# Islamic Finance: The Regulatory Challenge

Edited by

Simon Archer and Rifaat Ahmed Abdel Karim

# Islamic Finance

The Regulatory Challenge

An Islamic financial services sector is repidly developing to meet the burgeoning need for financial institutions that are not tracest-based, or which otherwise contravers the principles of Islamic commercial jurisprudence. The Islamic Financial Services Board 0FS6: was established in 2002 to guide the development of structured regulatory, supervisory, and legal fromeworks appropriate for the Islamic Financial services industry workdwide—an industry. Utal is increasingly attracting the attention of major international conventional financial institutions.

Islamic Finance: The flegulatory Challenge provides a comprehensive analysis of the issues that arise in the development of these new herneworks. Edited by two well known experts in the field of Islamic feserce, a draves on the relevant expertise of eminent specialists in international finance, regulation and economic law.

This book addresses issues such as:

- Why are the frameworks devised for the conventional financial sector unsuitable for Islamic financial services?
- What is the nature of risks in Islamic banking?
- \* What is the potential for proveth on the Islamic financial
- What is the potential for growth on the Islamic financial astroices sector?
- for innovatory islamic financial products?

  What are the specific corporate governance and
- How can frameworks be developed that cater for both the Islamic and conventional financial sectors in amerging market countries in which Islamic financial services are exceeded to play an increasing reference.

Islamic Finance: The Regulatory Challenge sheds much needed light on these issues, and more. As such, it should be considered as required reading for anyone interested in the potential role of Islamic finance in national and international financial and capital markets.

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Hamid also advises the Islamic Financial Services Board, the global standard-setting body for the Islamic financial industry, and, in particular, has advised it on the latest issue of its "Guiding Principles on Corporate Governance for Institutions offering Islamic Financial Services."

#### Foreword

In a global environment that has become increasingly challenging, Islamic finance has experienced rapid expansion and is fast emerging as a viable and competitive form of financial intermediation with significant potential. The integration of Islamic finance with international financial markets and institutions has demonstrated its resilience and sustainability in the international financial system. Islamic finance holds the promise for an inclusive and inherently stable financial system, the potential of which is yet to be fully realized.

The Shari'ah permits a wide array of deposits taken on the principles of bailment, partnership, and investment which are not contemplated by the common law. Islamic modes of finance give rise to Islamic banking assets which range from products that are similar to conventional banking products, to risk sharing assets that are unknown in conventional banking.

Islamic banking is also truly universal banking as it encompasses both banking and securities businesses. A significant part of Islamic banking business is fee-based activities, not only in retail banking business but also in corporate and capital market businesses.

In addition, as mudarib or entrepreneur, the Islamic bank makes judicious forays by way of direct participation into the investments in the real sector of the economy, a role that is not played by conventional banking. Given these unique features, the rapid expansion of Islamic finance needs to be supported by a strong regulatory and supervisory regime. Therefore, there is a need to fully comprehend Islamic banking and finance, to correctly identify and recognize the various credit, operational and market risks as well as other risks that are inherent in the Islamic banking business. This would form the basis for the regulatory regime and coporate governance framework that adequately addresses the uniqueness of Islamic banking and finance. This is the challenge for the regulators. The regulatory regime needs to be, however, sufficiently flexible to promote innovation and the origination of various new and relevant Shari'ah-compliant financial products. The high demand in the banking and financial markets for these financial products and services increases the urgency for having in place the regulatory regime that promotes its orderly and sound development.

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In this respect, the work that is being undertaken by the Islamic Financial Services Board (IFSB) to develop universally acceptable prudential, regulatory, and supervisory standards that are in compliance with the Shari'ah will indeed contribute towards the overall efforts to enhance and strengthen the stability of the international financial system,

Islamic Finance: The Regulatory Challenge edited by two eminent scholars and practitioners in Islamic finance, Professors Rifaat Ahmed Abdel Karim and Simon Archer, is therefore timely and a truly welcome addition to the growing literature on the subject. It sheds light on the various unique characterisitics of Islamic banking and finance, the players and the other participants in the industry. It also discusses extensively the issues for evolving prudential best practices, regulatory standards, corporate governance principles and accounting conventions in Islamic finance. I congratulate the two for their fine contribution to the evolving art and science of the regulation of Islamic finance.

Dr. Zeti Akhtar Aziz Governor Bank Negara Malayasia

## Preface

There is now great interest, both in financial and legal circles, in reliable and authoritative texts on Islamic finance. I have no doubt that the availability of *Islamic Finance: The Regulatory* Challenge will be warmly welcomed by those who provide financial and legal services. The work will be of great assistance to them.

The editors and the contributors write with great authority and clarity on a wide range of subjects which are of great relevance and interest. I am confident that those who read *Islamic Finance: The Regulatory Challenge*, will find that they are fully equipped to deal with the many challenges that the subject raises. In the days of global financial markets, this subject is of the greatest importance and should not be neglected.

It is therefore very reassuring to know that in this book, there is now available information that is needed by all who are involved in financial markets. I am confident that this book will have the success it deserves.

> The Rt Hon the Lord Woolf of Barnes Law Lord and Former Lord Chief Justice of England & Wales

# Acknowledgments

We would like to thank each of the contributing authors for taking the time to write their chapters. Their insights and practical experiences have made the book much richer.

Special thanks go to Marni Rafiza Mohammad for her enthusiastic support. Her relentless energy and valuable assistance have made this book possible.

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# Supervision of Islamic Banks and Basel II: The Regulatory Challenge

Simon Archer and Rifaat Ahmed Abdel Karim

#### 1. INTRODUCTION

The challenge to banking regulators and supervisors represented by the Basel Committee for Banking Supervision (BCBS) document International Convergence of Capital Measurement and Capital Standards: A Revised Framework (generally known as Basel II) is, of course, first and foremost in respect of its application to conventional banks. Basel II was issued in June 2004 (with some revisions in November 2005) to supersede the original 1988 Capital Accord (Basel I). The main innovations introduced in Basel II were, first, a significantly more comprehensive and sophisticated approach to measuring credit risk and, second, a capital requirement for operational risk. With respect to market risk, Basel II did not supersede the 1996 Amendment of Basel I, which had introduced a capital treatment for this category of risk, not specifically covered in the original capital accord.

Basel I was a document of modest length that made no great technical demands on the reader. However, the years since 1988 have seen a very significant evolution in banking and finance, including the effects of the globalization of financial markets and developments such as the abundance of derivatives and securitizations using structured finance. These developments have significant implications for risk and capital adequacy. Hence, Basel II, which (with its appendices) runs to over 250 pages, is a fairly daunting document that makes some non-trivial demands on the reader, both technical and conceptual.

Basel II was not written with its application to Islamic banking in mind. However, the rapid development of Islamic banking since the early 1990s, and the fact that international financial authorities such as the World Bank, the International Monetary Fund (IMF), and the BCBS understood the consequent desirability of building bridges between Islamic (Shari'ah-compliant) financial institutions and the conventional (non-Shari'ah-compliant) financial sector,<sup>2</sup> inevitably raised the issues of how and to what extent Basel II principles and techniques are applicable to the regulation and supervision of Islamic banks, and of the regulatory and supervisory problems to be overcome in this context.<sup>3</sup> These issues constitute the concern of this book.

#### 2. THE STRUCTURE OF BASEL II: SUPERVISORY IMPLICATIONS

The structure of Basel II is based on three "Pillars." Pillar 1 deals with the new approach to credit risk which replaces that of Basel I and with operational risk; Pillar 2 addresses the supervisory review process from the standpoint of the responsibility of the supervisor to promote the overall safety of the banking system, and establishes a set of common guidelines for supervisory review, while also stressing the primary responsibility of individual banks and the critical role of dialogue between supervisors and banks; and Pillar 3 lays down a minimum number of public reporting standards on risk and risk management intended to enhance the ability of market participants to be aware of a bank's risk profile and the adequacy of its capital in relation to this, thus involving the market in the capital adequacy regime.<sup>4</sup>

Basel II thus presents all banking supervisors with a major challenge, both in enforcing Pillar 1 together with the disclosure requirements of Pillar 3, and in implementing Pillar 2. To be sure, the adoption of Basel II is not intended to be a requirement outside of the G10 countries who are represented on the BCBS, and then only for banks that are internationally active. However, as Basel I has been adopted in over 100 countries, the supervisors in these and other countries may be expected to adopt Basel II progressively over the next few years.

For supervisors in countries where Islamic banks are located, there is the further challenge of applying Basel II to those institutions. This

added challenge results from the specificities of the Islamic (Shari'ah-compliant) modes of finance employed by Islamic banks. These raise issues of capital adequacy, risk management, and corporate governance that differ significantly from those that arise in conventional (non-Shari'ah-compliant) financial institutions. The issues concern the types of assets to which Islamic financing gives rise, the related risks and the availability of risk mitigants, and the types of non-interest-bearing savings and investment products offered by Islamic banks for funds mobilization in place of conventional deposit and savings accounts. The fact that these non-interest-bearing savings and investment products have characteristics similar to those of collective investment schemes, not normally the concern of banking supervisors or regulators, constitutes a further regulatory challenge.

# 3. THE ISLAMIC FINANCIAL SERVICES

The Islamic Financial Services Board (IFSB) was launched in 2002 by a consortium of central banks and the Islamic Development Bank (and with the support of the IMF) with the mandate including the provision of prudential standards and guidelines for international application by banking supervisors in the supervision of Islamic banks.

In December 2005 the IFSB issued two prudential standards for Islamic banks that are designed to help supervisors of such banks meet the challenge of implementing Basel II, one on capital adequacy and one setting out guiding principles of risk management (together with an Exposure Draft of a third standard on corporate governance). The mandate of the IFSB was extended in December 2005 to the domains of insurance and securities market supervisors and regulators.

The main challenge for the IFSB is to develop a framework that is common and applicable to all jurisdictions. However, unlike the Basel Committee, which can rely on regulatory frameworks and best practices developed by other leading regulators and banks as a background to its global framework, this process could not be readily applied by the IFSB. This is because the IFSB does not have the privilege of borrowing ideas from a large number of countries that have developed robust regulatory frameworks specifically for Islamic banks. Hence, the onus of developing most of the thinking to set internationally accepted common prudential standards for Islamic financial institutions is on the IFSB. This involves identifying the risks in the different types of Islamic finance and activities, understanding the substance

as well as the form of the contracts that govern the transactions, dealing with issues that have not been addressed in other international standards, safeguarding the interests of other stakeholders who in principle share asset risks with the shareholders, and adapting Shari'ah rules that would be acceptable to the majority of its members.

#### 4. CONTENTS OF THIS BOOK

Since this book deals with a large range of regulatory issues arising from the application of Basel II to Islamic banks, authors who have been chosen are specialists drawn from a variety of relevant backgrounds: international organizations such as the World Bank and the BCBS; banking supervisors; the legal and accounting professions; banks and financial institutions; international credit rating agencies; and academia. The book is organized into four main parts, reflecting different aspects of the regulatory challenge, and two concluding chapters, as outlined below.

## Part 1: The Nature of Risks in Islamic Banking

This part consists of seven chapters from 2 to 8. In Chapter 2, Hennie van Greuning and Zamir Iqbal examine banking and the risk environment with reference to Islamic banks. They look at how Shari'ah-compliant financial intermediation operates in theory and in practice, and the risks, and corporate governance and transparency issues, to which this gives rise to. The risk characteristics of Islamic products, and the complexities of some of these, such as the phenomenon of displaced commercial risk, are rigorously examined in Chapter 3 by Venkataraman Sundararajan. Chapter 4, by Wafik Grais and Anoma Kulathunga, deals with capital structure and risk in Islamic banks. They consider issues of efficient risk management in relation to the level of capital and capital structure and to the nature of Islamic financing assets. The next two chapters focus on specific types of risks in Islamic banks. Credit and market risks inherent in asset-side products are examined by John Lee Hin Hock and Abdullah Haron in Chapter 5. They show how Islamic financing assets possess risk characteristics not found in conventional loans, including combinations of credit and market risks. Consequential or operational risks are analyzed by Simon Archer and Haron Abdullah in Chapter 6. For Islamic banks, as they point out, operational risks include those that may arise from errors in drawing up contracts or in executing transactions that result in non-compliance with the Shari'ah which may have serious financial consequences. Chapter 7, by Yusuf Talal DeLorenzo and Michael McMillen, deals with a complex and daunting set of risks arising from Shari'ah and legal compliance requirements and their interactions, which result inter alia in legal impediments to the development of Islamic securitizations. The authors also provide a historical outline, from a legal perspective, of the emergence of modern Islamic banking and finance, Finally, Hari Bhambra in Chapter 8 considers the implications of these risks for a financial sector regulator. She concludes that matters are easier if the regulator is a cross-sectional regulator, responsible for securities markets and the insurance sector as well as banking. So far as Shari'ah compliance is concerned the regulator or supervisor does not need to take positions on issues of Shari'ah, but instead must satisfy itself as to the effectiveness of an Islamic bank's own systems and procedures for ensuring Shari'ab compliance, both ex ante (in the design of products and the associated contracts) and ex post (in contract execution and product delivery).

## Part 2: Capital Adequacy

This part contains four chapters. Chapter 9, by Charles Freeland and Steven Friedman, examines the need for bank capital in order to absorb banking risks, providing the rationales and historical background of the Basel I and II frameworks. There follows a chapter by the editors, Simon Archer and Rifaat Ahmed Abdel Karim, which highlights an important set of issues concerning the measurement of risk for capital adequacy purposes that results from the use by Islamic banks of profit-sharing and loss-bearing investment accounts in lieu of conventional bank deposit and savings products. In Chapter 11, Elisabeth Jackson-Moore deals with the measurement of operational risk for capital adequacy purposes. Among other things, she provides a suggested mapping of banking activities into business lines for operational risk measurement as required for the Standardised Approach under Pillar 1 of Basel II. Finally, the supervisory implications of the above are addressed by Toby Fiennes in Chapter 12. He states that it is quite possible for an Islamic bank to be both Shari'ah-compliant and Basel II-compliant, and refers to the work of the IFSB in facilitating this. But he identifies some problems: a higher level of operational and legal risk; Islamic "windows" in conventional banks; and the ambiguous situation of profit-sharing and loss-bearing

"deposit" accounts; what is the nature of the claims on the bank that the holders of such accounts are entitled to make, and what are the risk implications of these claims? He concludes by emphasizing the need for transparency.

### Part 3: Securitization and Capital Markets

There are three chapters in this part, Chapter 13, by Abdulkader Thomas, deals with the developing phenomenon of Islamic securitizations, or sukuk, emphasizing the distinction between the issuance of tradable securities that do not result in the derecognition of assets from the balance sheet and true asset securitizations resulting in derecognition (the latter being rare for reasons discussed in Chapter 7). The author concludes that the rapid development of the Islamic finance space, with the emergence of new opportunities and methods to serve clients better, must ultimately lead to business activities that require more active balance sheet management (including securitizations that result in asset derecognition) than has been hitherto performed by Islamic banks. In Chapter 14, Stella Cox considers the opportunities and challenges in the Islamic capital and money markets, and particularly the need to create a Shari'ah-compliant asset base and financial infrastructure for the creation of liquid Shari ah-compliant assets. The regulation of Islamic capital markets is discussed by Robert Gray in Chapter 15. He points out that the legal and regulatory environments in the most advanced capital markets (such as those of the United States and Europe) are not unfriendly to Islamic finance and to the issuance of Islamic securities. U.K. law has served as the basis for sukuk issues in a number of Islamic countries, while many of the most successful international sukuk transactions have been made in compliance with the guidelines in U.S. Regulation S for the offering of securities outside the United States. However, Gray calls for the introduction of non-mandatory guidelines to regulate non-Islamic institutions offering Islamic capital market products.

#### Part 4: Corporate Governance

This part contains four chapters. The first, Chapter 16 by Hamid Yunis, considers issues of corporate governance as they apply to banks. Chapter 17, by the editors, examines specific corporate governance issues in Islamic banks, notably those raised by the requirement for compliance with the *Shari'ah*, and those resulting from the use

by Islamic banks of profit-sharing and loss-bearing savings and investment products in place of conventional deposit and savings accounts. In Chapter 18, Chizu Nakajima and Barry Rider examine corporate governance and supervision from a Basel Pillar 2 perspective, with particular reference to problems of the legal environment and of regulatory over-reaction to certain types of threat. In Chapter 19, David Vicary considers the transparency and market discipline implications for Islamic banks of Basel Pillar 3, indicating the potential key role of the regulator in promoting or "bootstrapping" a virtuous circle of transparency.

#### Part 5: Conclusion

In the first of two concluding chapters, Chapter 20, Volker Nienhaus examines the human resource management implications of the conceptual and technical challenges facing the Islamic banking sector, including the need to recruit, train, motivate, and retain highly competent personnel in an environment rendered highly competitive by rapid growth and the presence of the major international banks. Finally, Chapter 21 by the editors presents some overall conclusions.

#### **ENDNOTES**

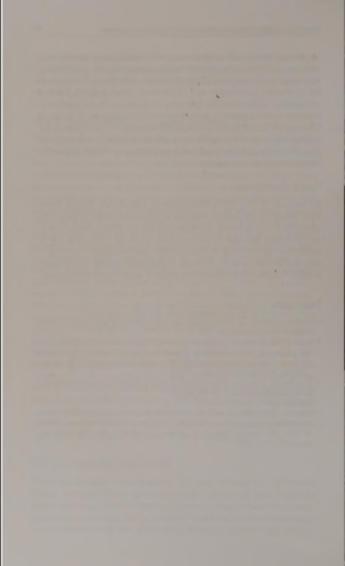
For further details and a historical background, see Freeland and Friedman (2006), Chapter 9 in this volume.

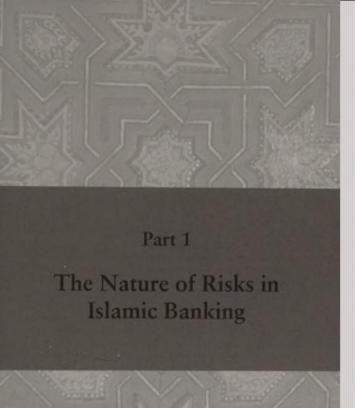
<sup>&</sup>lt;sup>2</sup> In part, this was due to a series of conferences organized by one of the editors of this volume, then Secretary-General of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), notably the Conference on Regulation of Islamic Banking held in February 2000.

<sup>&</sup>lt;sup>3</sup> The essential differences between conventional and Islamic financial intermediation are explained in Chapter 2 of this volume.

<sup>4</sup> Freeland and Friedman, loc. cit.

Exposure Drafts of IFSB standards on the supervisory review process (Pillar 2) and transparency and market discipline (Pillar 3) are due to be issued in the second half of 2006. The Exposure Draft on Corporate governance is due to be issued as a standard in early 2007.











# Banking and the Risk Environment

Hennie van Greuning and Zamir labal\*

#### 1. INTRODUCTION

S ince the emergence of "Islamic" banks in the early 1970s, considerable research has been conducted focusing mainly on the viability, design, and operations of a "deposit-accepting" financial institution that operates primarily on the basis of profit and loss partnerships rather than interest.

During this period, Islamic financial institutions (IFIs) have made significant progress and achieved steady high growth despite several obstacles, impediments, and challenges. Growth was led mainly by the initiatives of the private-sector Islamic and conventional financial institutions in pursuit of capturing an emerging market as a result of increased demand for products compatible with an Islamic economic and financial system in both Muslim and non-Muslim countries. Islamic banks have worked closely with some of the leading conventional financial institutions in a cooperative as well as competitive fashion. As a result, IFIs have earned due recognition in global financial markets which has paved the way for rapid growth of the Islamic financial services industry.

Whereas the emergence of Islamic banks in the global markets was a significant development, it in no way compares to the enormous changes that have taken place in the conventional banking industry. Rapid innovations in the financial markets and the internationalization of financial flows have changed the face of conventional banking almost beyond recognition. Technological progress and deregulation have provided new opportunities, increasing competitive pressures among banks and non-banks alike. The growth in international financial markets and a greater diversity of financial instruments have provided large banks with wider access to funds. In the late 1980s, margins attained from the traditional business of banking diminished and capital adequacy requirements increased. Banks have responded to these new challenges with vigor and imagination by forging ahead into new arenas. At the same time, markets have expanded and opporrunities to design new products and provide more services have arisen. While these changes have taken place more rapidly in some countries than in others, banks everywhere are becoming more involved in developing new instruments, products and services, and techniques. Traditional banking practice - based on the receipt of deposits and the granting of loans - is today only one part of a typical bank's business, and is often its least profitable activity.

New information-based activities, such as trading in financial markets and income generation through fees, are now major sources of a bank's profitability. Financial innovation has also led to the increased market orientation and marketability of bank assets, using assets such as mortgages, automobile loans, and export credits as backing for marketable securities, a process known as securitization. A prime motivation for innovation has been the introduction of prudential capital requirements, which has in turn led to a variety of new financial instruments. Some instruments are technically very complicated and are poorly understood except by market experts, while many others pose complex problems in terms of risk measurement, management, and control. Moreover, profits associated with some of these instruments are high, and like the financial markets from which they are derived are also highly volatile, and they thus expose banks to new or higher degrees of risk.

These developments have increased the need for and complicated the function of risk measurement, management, and limiting risks (control assessment). The quality of corporate governance of banks has become a hot topic, and the approach to regulation and supervision has changed dramatically. Within an individual bank, the new banking environment and increased market volatility have necessitated an integrated approach to asset/liability and risk management techniques.

Rapid developments in conventional banking have also influenced the re-shaping of Islamic banks and financial institutions. Looking forward, there is a growing realization among IFIs that sustainable growth critically depends on the development of a comprehensive risk management framework. At the same time, policy makers and regulators are taking serious steps to design an efficient corporate governance structure as well as a sound regulatory and supervisory framework to help develop a financial system conducive to the principles of the Islamic financial system.

With this background, this chapter focuses on three major aspects of banking – that is, banking risk, corporate governance, and transparency. Each aspect plays a critical role in the development of an emerging market such as Islamic banking. The purpose is to indicate the overall relevance of each to Islamic banking and to enhance our understanding of issues specific to Islamic banking.

#### 2. BANKING RISK

Understanding banking risk in a competitive and volatile market environment is a complex process. In addition to effective management and supervision, other factors necessary to ensure the safety of banking institutions and the stability of financial systems and markets include sound and sustainable macroeconomic policies and well-developed and consistent legal frameworks. Adequate financial sector infrastructure, effective market discipline, and sufficient banking sector safety nets are also crucial. To attain a meaningful assessment and interpretation of particular findings, estimates of future potential, a diagnosis of key issues, and formulation of effective and practical courses of action, a bank analyst must have extensive knowledge of the particular regulatory, market, and economic environment in which a bank operates. In short, to be able to do the job well, an analyst must have a holistic perspective on the financial system even when considering a specific bank.

Banks are subjected to a wide array of risks in the course of their operations, as illustrated by Exhibit 2.1. In general, banking risks fall into four categories: financial, operational, business, and event risks. Any of these risk categories can be further divided into sub-categories.

Financial risks are subject to complex interdependencies that may significantly increase a bank's overall risk profile. For example, a bank engaged in foreign currency business is normally exposed to currency risk, but will also be exposed to additional risks such as liquidity, credit, and re-pricing if it carries open positions or mismatches in its forward book. Operational risks are related to a bank's overall

EXHIBIT 2.1 Banking risk exposures

Financial risks	Operational risks	Business risks	Event risks
Balance sheet structure	Internal fraud.	Macro policy	Political
Income statement structure and External fraud profitability	External fraud	Financial infrastructure	Contagion
Capital adequacy	Employment practices and workplace safety	Legal infrastructure	Banking crisis
Credit	Clients, products, and business services	Legal liability	Other exogenous
Liquidity	Damage to physical assets	Regulatory compliance	
Market	Business disruption and system failures (technology risk)	Reputational and fiduciary	,
Interest rate	Execution, delivery, and process management	Country risk	
Currency			

organization and functioning of internal systems, including computerrelated and other technologies; compliance with bank policies and procedures; and measures against mismanagement and fraud. Business risks are associated with a bank's business environment, including macroeconomic and policy concerns, legal and regulatory factors, and the overall financial sector infrastructure such as payment systems and auditing professions. Event risks include all types of exogenous risks, which, if they were to materialize, could jeopardize a bank's operations or undermine its financial condition and capital adequacy.

#### 2.1. Risk Analysis

The practices of bank supervisors and the appraisal methods practiced by financial analysts continue to evolve. This evolution is necessary in part to meet the challenges of innovation and new developments, and in part to accommodate the broader process of convergence of international supervisory standards and practices, which are themselves continually discussed by the Basel Committee on Banking Supervision. Traditional banking analysis has been based on the use of a range of quantitative supervisory tools to assess a bank's condition, including ratios. Ratios normally relate to liquidity, the adequacy of capital, loan portfolio quality, insider and connected lending, large exposures, and open foreign exchange positions. While these measurements are extremely useful, they are not in themselves an adequate indication of the risk profile of a bank, the stability of its financial condition, or its prospects.

An analytical review normally comprises a review of financial conditions and specific issues related to risk exposure and risk management. In addition to verifying the conclusions reached during off-site reviews, on-site reviews cover a much larger number of topics and are more concerned with qualitative aspects, including the availability and quality of management information. The questions asked during all phases of the analytic review process should focus on:

- · what happened
- · why it happened
- · the impact of the event/trend
- · the response and strategy of the bank's management
- the recommendations of the analyst
- · what vulnerabilities should be highlighted.

The analytical review of banks follows a number of stages whereby the results of one stage serve as inputs to the next. The ultimate objective of this process is a set of recommendations that, if properly implemented, result in a safe, sound, and properly functioning financial intermediary.

The central technique for analyzing financial risk is the detailed review of a bank's balance sheet. Risk-based bank analysis includes important qualitative factors, and places financial ratios within a broad framework of risk assessment and risk management and changes or trends in such risks, as well as underscoring the relevant institutional aspects. Such aspects include the quality and style of corporate governance and management; the adequacy, completeness, and consistency of a bank's policies and procedures; the effectiveness and completeness of internal controls; and the timeliness and accuracy of management information systems and information support.

A risk-based bank analysis should also indicate whether an individual institution's behavior is in line with peer group trends and/or industry norms, particularly when it comes to significant issues such as product risk, profitability, structure of the balance sheet, and capital adequacy. A thorough analysis can indicate the nature of and reasons for such deviations. The meaningful change in risk profile experienced by an individual institution could either be the result of unique circumstances that have no impact on the banking sector as a whole, or could be an early indicator of trends that might be followed by other banks.

The picture reflected by financial ratios also largely depends on the timeliness, completeness, and accuracy of data used to compute them. For this reason, the issue of usefulness and transparency is critical, as well as that of accountability, which has become an important topic due to both the increasing importance of risk management for modern financial institutions and the emerging philosophy of supervision.

# 2.2. Financial Intermediation of Islamic Financial Institutions: Theory

For IFIs, such analysis must incorporate the nature of the contracts and a fundamental understanding of how risk is allocated or shared. The nature of financial intermediation, including the function of banking, is different in the case of Islamic banks. This difference in intermediation is the key to understanding the different nature of risk in conventional and Islamic banking. For Islamic banks the mudarabah contract is the cornerstone of financial intermediation and thus of banking. The basic concept is that both funds mobilization and (in theory) funds utilization are on the same basis of profit sharing among the depositors, the bank, and the entrepreneur. A typical Islamic bank will perform the functions of financial intermediation through screening profitable projects and monitoring the performance of projects on behalf of the investors who deposit their funds with the bank. However, in practice, funds are mainly applied by means of commodities and asset financing instruments that avoid interest but are not profit sharing, such as murabahah, salam, istisna'a, and ijarah, as indicated below.

A stylized balance sheet of an Islamic bank, displaying various activities and financial instruments, is shown in Exhibit 2.2. It can serve as a good starting point for understanding the dynamics of the risk inherent in Islamic banks.

#### Liabilities

The balance sheet is based on the "two windows" theoretical model of an Islamic bank. In addition to equity capital, this model divides the "liability" or funding side of the bank balance sheet into two deposit windows, one for demand deposits and the other for investment/special investment accounts. The choice of window is left to the depositors. Investment accounts are not, in fact, liabilities, as explained below. In addition, special or restricted investment accounts

Assets Liabilities Demand deposits Short-term trade finance (murabahah/salam) (amanah) Investment accounts Medium-term investments (mudarabah) (liarah/istisna'a) Special investment accounts (mudarabah/musharakah) Long-term partnerships (musharakah) Reserves Fee-based services Equity capital (ioala, kifala, etc.)

EXHIBIT 2.2 Theoretical balance sheet of an Islamic bank

are often shown as off-balance sheet funds under management, which is considered by some analysts to be more appropriate given the nature of these accounts and the fact that only the unrestricted investment account funds are commingled with the bank's other funds (from shareholders' equity and demand depositors).

A 100% reserve is required for demand deposits (but no reserve requirement is stipulated for the second window). This 100% requirement is based on the presumption that the monies deposited as demand deposits are placed as amanah (for safe keeping), that they are repayable on demand and at par value, and that they are not expected to be invested; therefore, money creation through the multiplier effect must be limited.

Money deposited in investment accounts, on the other hand, is placed with the depositor's full knowledge that his deposit will be invested in risk-bearing projects; therefore, no guarantee is justified. Investment account holders are investors/depositors who enter into a mudarabah contract with the bank, where investors act as the supplier of funds (rab al mal) to be invested by the bank on their behalf as mudarib. The investors share in the profits accruing to the bank's investments on the assets side. Such profit-sharing investment deposits are not liabilities. Investors' capital is not guaranteed, and they incur losses if the bank does; the form is closer to that of limited-term, non-voting equity or a trust arrangement. Some Islamic banks also offer "special investment accounts" developed on the basis of special purpose or restricted mudarabahs or on profit and loss sharing (musharakah). These special investment accounts are similar to closed-end mutual funds, and are highly customized and targeted toward high-net-worth individuals.

#### Assets

On the assets side, Islamic banks have more choice and diversity of instruments with different maturities and risk-return profiles. For short-term maturities, trade financing or financial claims resulting from a sale contract – that is, murabahah, salam, and so on – are available. For medium-term investments, leasing (ijarah), istisna'a, and various partnerships are possible; and for long-term partnership, investments in the form of partnership (musharakah) can be undertaken. An Islamic financial intermediary may also engage an external entrepreneur on a mudarabah basis such that the bank acts as principal and the entrepreneur as agent. In this capacity, an Islamic bank can

form a syndication with other financial or non-financial institutions to provide medium- to long-term capital to entrepreneurs. Finally, like any conventional bank, Islamic banks also provide customized services, guarantees, and underwriting services for a fee.

Exhibit 2.3 expands on Exhibit 2.2 and shows the various roles an Islamic bank assumes on the assets and "liabilities" sides of its balance sheet. This exhibit can provide us some insight into the nature of risks created by the form of intermediation. This nature of intermediation has two major implications that distinguish Islamic financial intermediaries from conventional banks; first, the relationship between the depositors and the bank is based on profit- and loss-sharing principles; and second, the asset side of the bank includes risky assets (mudarabah and musharakah) that a conventional bank may not carry. Furthermore, Islamic banks mix different types of banking activities, such as brokerage, commercial, and investment banking, similar to a universal bank. On theoretical grounds, it has been argued that a well-diversified portfolio on the assets side, and the nature of the contract between the bank and the investors on the basis of profit and loss, will ensure efficiency and stability in the system. The bank does not carry any risk on its books, as all risks are shared with the investors/depositors and the bank is liable only for any negligence or misconduct. The next section discusses how Islamic banking is practiced and how it changes the risk environment.

# 2.3. Financial Intermediation of Islamic Financial Institutions: Practice

The balance sheet and contractual relationships shown in Exhibit 2.2 may not be representative of the majority of the banks currently in business, for several reasons. On the "liabilities" side, it is common practice to accept deposits on the basis of profit and loss sharing, but it is the assets side that deviates most from the theoretical model. There are at least three major modifications of the theoretical balance sheet that have, either directly or indirectly, implications for the overall riskiness of the banking environment, as discussed below.

#### The trend toward less risky short-term assets

On the assets side, the majority of banks have limited themselves to less risky trade-financing assets, which tend to be of shorter maturity. This aspect is a significant deviation, in terms of the structure of assets, from

EXHIBIT 2.3 Islamic banking: Risk and contractual role

		Risk/cor	Risk/contractual role of IFIs	of HFIs.
	Contract	Trustee	Partnership	Principal/agent
	Link to conventional finance	Agency/brokerage	Investment	Conventional/ commercial banking
Liabilities - funding sources				
Demand deposits	Amana (Trust)	N		
Investment accounts	Mudarabak			4
Special investment accounts	Mudarabah			7
	Musharakah (Partnership)		7	
Equity - shareholders' funds	Musharakah (Partnership)		N	
Assets - application of funds				
Short-term trade financing				
	Murabahah			7
	Bay salam			1
	Bay mua'ajal			V
Medium-term investments				
	Ijarah, Istisna'a		7	7
	Mudarabah, Musharakah		×	7
Long-term partnerships				
	Mudarabah, Musharakah		1	
			7	
Fee-based services				
	Joa la, Kifala, efc.	1	7	7

what the theoretical models and basic principles of Islamic finance would lead one to anticipate. A clear preference for asset-backed financial claims resulting from sale and trade therefore becomes evident. This preference is due to the fact that sale-related securities are considered as low-risk and resemble familiar, conventional fixed-income securities in terms of their risk-return profile. In addition to trade-based instruments, Islamic banks prefer leasing, which is considered to carry a lower risk and to have less uncertain returns than partnership-based instruments such as musharakah or mudarabah. In a typical case, sale- and lease-based transactions dominate the assets portfolio and can exceed 80%, with the remainder allocated to profit-sharing arrangements. On average, as a mode of financing, murabahah (41%) has been the first choice of Islamic banks, followed by musharakah (11%), mudarabah (12%), ijarah (10%), and others (26%).

Islamic banks' over-dependence on trade and commodity financing instruments has limited their choice of maturity structure, as a major portion of such financing is of short-term maturity. Whereas the theoretical model expects financial intermediaries to participate in a full range of maturity structures to get the benefits of portfolio diversification, in reality, Islamic banks shy away from instruments requiring a medium- or long-term commitment. A cursory view of data on the asset maturities collected from six Islamic banks as of 2003 shows that 54% of their assets had a maturity of less than one year and 39% of less than six months. Islamic banks tend not to invest in longer-maturity assets due to the lack of liquidity of medium- to long-term assets. Due to the reliance on short-term maturity, Islamic banks are very restricted in their ability to offer investment opportunities to investors who are interested in long-term investments.

#### Low participation in profit-/loss-sharing arrangements

Whereas the theoretical model advocates the promotion of profit- and loss-sharing arrangements, banks' participation in these instruments is low. Banks are reluctant to indulge in profit-/loss-sharing instruments for several reasons, including their inherent riskiness and the banks' low appetite for risk, the additional monitoring costs associated with such instruments, the lack of transparency in markets within which Islamic banks are operating, and the reluctance of the banks' depositors to take risks. This factor could be a reflection of the

low level of transparency in the banking system, which leads to a low level of trust between investors/depositors and the banks and, consequently, to reluctance by depositors to take long-term and risky positions with banks. The result is that the depositors tend to be risk averse, and therefore the banks become risk averse, and although they may have good investment opportunities on the basis of profit and loss sharing, they may not be able to find depositors who are willing to take the risk.

Islamic banks often complain that there is no institutional infrastructure to support profit and loss sharing. There are no supporting institutions to maintain good-quality information on the credit standing of borrowers and entrepreneurs. There are very few credible trade associations to conduct common monitoring and to share information about debtors. In the presence of informational asymmetry in the system, the banks tend to shy away from equity- and partnership-based instruments. Consequently, portfolios of banks are often not diversified either geographically or in terms of products. They are exposed to specific sectors or geographical regions, which is not healthy and leads to an increased level of banking environment risk.

### Lack of clarity between shareholders and investors/depositors

The theory states that the contractual agreement between the bank and the investors/depositors should be based on a "pass-through" mechanism where all profits and losses are passed to the depositors/investors. It is often stated that one of the most critical and distinguishing features of the financial intermediation by Islamic banks as compared to conventional banks is the inherent design by which the assets and liabilities sides of the Islamic bank's balance sheet are matched.3 In the case of a conventional bank, deposits are accepted at a pre-determined rate irrespective of the rate of return earned on the assets side of the bank. This instantaneously creates a fixed liability for the bank, without any certainty that the bank would be able to earn more than it promised or was committed to pay to the depositors. Since the return on the assets depends on the bank's ability to invest the funds at a higher rate than that promised on the liability side, and this rate is unknown, it can lead to the classic risk management problem of a mismatch between assets and liabilities. In contrast, for Islamic banks there is no pre-determined rate on the deposits/investment accounts, and the depositors are expected to share the profits and losses incurred on the asset side of the bank, so that there is no problem of asset-liability mismatch. It has been argued that due to this "pass-through" nature of the business and closely matched assets and liabilities, this type of financial intermediation contributes to the stability of the financial system.

However, the practice is very different. There is no clear differentiation between the shares of investors/depositors and those of the equity holders. The transparency of determining each stakeholder's share is low, as policies and procedures for the computation and declaration of profits and losses are not well defined. In some cases, the practice is not truly a "pass-through" arrangement. There have been incidents where profits were distributed to investment account holders despite losses on the assets, so that the profits were paid out of equity. This phenomenon has been termed "displaced commercial risk." Due to the absence of a "pass-through" arrangement, the banks thus expose themselves to assets—liabilities mismatch risk (otherwise known as rate-of-return risk, an analogue of interest rate risk in a conventional bank's banking book).

All of the above-mentioned deviations between the theory and practice mean that the system is not functioning at its full potential and has adapted itself to a limited functionality. These deviations and other practices of the banks have led to increased riskiness – or at least the perception of it – at the institutional and systemic level.

#### 3. CORPORATE GOVERNANCE

The issue of corporate governance has recently received considerable attention in the conventional economic literature and public policy debates. This increased attention can be attributed to several factors, such as: (a) the growth of institutional investors - that is, pension funds, insurance companies, mutual funds, and highly leveraged institutions, and the role which institutional investors play in the financial sector, especially in major industrial economies; (b) widely articulated concerns and criticism to the effect that the contemporary monitoring and control of publicly held corporations in Englishspeaking countries, notably the United Kingdom and the United States, is seriously defective, leading to sub-optimal economic and social development; (c) a shift away from a traditional "shareholder value-centered" view of corporate governance in favor of a corporate governance structure extended to a wide circle of stakeholders; and (d) the impact of increased globalization of financial markets, a global trend of deregulation of financial sectors, and liberalization

of institutional investors' activities which have raised concerns over corporate governance.

As discussed, liberalization and the volatility of financial markets, increased competition, and diversification expose banks to new risks and challenges, requiring the continuous innovation of ways to manage the business and its associated risks in order to remain competitive. The increasing market orientation of banks has also necessitated changes in the approach to regulation and supervision. The responsibility for maintenance of the banking system and markets is being redefined, in one country after another, as a partnership among a number of key players who manage various dimensions of financial and operational risks. This approach reconfirms that the quality of bank management, and especially the risk management process, are the key concerns in ensuring the safety and stability of both individual banks and the banking system as a whole.

Corporate governance relates to the manner in which the business of the bank is governed, including setting corporate objectives and a bank's risk profile, aligning corporate activities and behaviors with the expectation that the management will operate in a safe and sound manner, and running day-to-day operations within an established risk profile, while protecting the interests of depositors and other stakeholders. It is defined by a set of relationships between the bank's management, its board, its shareholders, and other stakeholders.

The key elements of sound corporate governance in a bank include:

- A well-articulated corporate strategy against which the overall success and the contribution of individuals can be measured.
- Assigning and enforcing responsibilities, decision-making authority, and accountabilities that are appropriate for the bank's risk profile.
- A strong financial risk management function (independent of business lines), adequate internal control systems (including internal and external audit functions), and functional process design with the necessary checks and balances.
- Adequate corporate values, codes of conduct and other standards of appropriate behavior, and effective systems used to
  ensure compliance. This includes special monitoring of a bank's
  risk exposures where conflicts of interest are expected to appear
  (for example, in relationships with affiliated parties).

 Financial and managerial incentives to act in an appropriate manner offered to the board, management, and employees, including compensation, promotion, and penalties. (That is, compensation should be consistent with the bank's objectives, performance, and ethical values.)

Exhibit 2.4 portrays a risk management partnership in which each key player has a clearly defined accountability for a specific dimension of every risk area. The workings of the risk management partnership may be summarized as follows:

EXHIBIT 2.4 Partnership in corporate governance of banks

Financial and other risk management areas  Key players and responsibilities	Balance sheet struct structure & profitabil Solvency risk and capital adequacy Credit risk Treasury management Investment Portolic Management Proprietary Trading Portfolio Management That asset-lability Management Curtency risk Currency risk Operational risk
Systemic (key players)	Accountability (dimension of risk for which key player is responsible)
Legal and regulatory authorities	Set regulatory framework, including risk exposure limits and other risk management parameters, which will <b>optimize</b> risk management in the banking sector
Supervisory authorities	Monitor financial viability and effectiveness of risk management.  Check compliance with regulations
Shart'sh board	Ensure that the financial Institution compiles with the rules of Sharfah in its Investment activities and managerial behavior, and protects the rights of depositors and all other stakeholders.
Institutional (key playe	ers):
Shareholders	Appoint "fit and proper" boards, management, and auditors
Board of directors	Set risk management and other bank policies. Utimate responsibility for the entity
Executive management	Create systems to implement board policies, including risk management, in day-to-day operations
Audit committee/ internal audit	Test compliance with board policies and provide assurance regarding corporate governance, control systems, and risk management processes
External auditors	Express opinion and evaluate risk management policies
External auditors Public/consumer (key players):	
Public/consumer	
Public/consumer (key players):	Express opinion and evaluate risk management policies  Understand responsibility and insist on proper disclosure.

- Bank regulators and supervisors cannot prevent bank failures.
  Their primary role is to act as facilitators in the process of
  risk management and to enhance and monitor the statutory
  framework in which risk management is undertaken. By creating a sound, enabling environment, they have a crucial role in
  influencing the other key players.
- Shari'ah boards at the institutional and systemic level have
  a great responsibility to protect the rights of all stakeholders
  according to the principles of Shari'ah. Shari'ah boards carry
  the trust of the investors/depositors, as well as of the users of
  the funds, to ensure that the institution is fully compliant with
  the Shari'ah in all its activities, whether the customer is an
  investor/depositor or an entrepreneur who wishes to engage in
  Shari'ah-compliant financing.
- Ultimate responsibility for the way in which a bank's business is conducted lies with the board of directors. The board has to set the strategic direction, appoint management, establish operational policies, and, most importantly, take responsibility for ensuring the soundness of the bank.
- Executive management of a bank has to be "fit and proper,"
  meaning not only that managers subscribe to standards of
  ethical behavior, but also that they have the competence and
  experience to run the bank. Because the management is responsible for implementing the board's policies through its running
  of the bank on a day-to-day basis, it is vital that it has intimate
  knowledge of the financial risks that are being managed.
- The audit committee and the internal auditors should be regarded as an extension of the board's risk management policy function. The internal auditors traditionally performed an independent appraisal of a bank's compliance with its internal control systems, accounting practices, and information systems. Most modern internal auditors would, however, describe their task as providing assurance regarding the bank's corporate governance, control systems, and risk management processes. Although audit committees play a valuable role in assisting management in identifying and addressing risk areas, the prime responsibility for risk management cannot be abdicated to them, but rather should be integrated into all levels of management.
- External auditors have come to play an important evaluative role in the risk-based financial information process. Since bank

supervisors neither can nor should repeat the work done by external auditors, proper liaison mechanisms are necessary between these two parties, particularly on a trilateral basis that includes bank management. The audit approach should be risk-oriented, rather than based on a traditional balance sheet and income statement audit. Over-reliance on external auditors would weaken the partnership, especially if it leads to a weakening of the management and supervisory roles.

- The public/depositors as market participants have to accept responsibility for their own investment decisions. In order to do so, they require transparent disclosure of financial information and informed financial analyses. The public can be assisted in its role as risk manager if the definition of public is widened to include the financial media, financial analysts such as stockbrokers, and rating agencies. The small or unsophisticated depositor would normally need more protection than simply transparent disclosure.
- Shareholders are in a position to appoint the people in charge of the corporate governance process and their conduct should be carefully screened to ensure that they do not intend to use the bank solely to finance their own or their associates' enterprises.

All of the above-mentioned players will play a similar critical role in the governance of an Islamic financial institution. However, the governance of IFIs is different in the ways discussed below.

# 3.1. Stakeholder-oriented Governance Framework: An Islamic Perspective on the Partnership between the Key Players

The Islamic economic system fully endorses a stakeholder view of governance based on Islam's principles of preservation of property rights and the sanctity of contracts. The corporate governance model in an Islamic financial system can be derived from a comprehensive understanding of three principles of Islam:

- recognition of property rights of individuals, legal entities (that is, firms), the community, and the state
- significance of contractual obligations, explicit as well as implicit, among economic agents
- the design of incentive systems to enforce Shari'ah rules in order to preserve social order.

Fundamental economic and ideological (theological) differences in property rights principles and the treatment of contracts in Islam differentiate the role of a legal entity from a conventional system in terms of objective functions and obligations, Islam is a rulebased system where rules are defined to protect the rights of each member of the society individually and collectively. The design of a corporate governance system in the Islamic financial system entails implementation of a rule-based incentive system such that compliance with the rules will ensure an efficient governance system to preserve social justice and order among all members of society. A paradigm shift is taking place in the conventional economic system, which has traditionally been an advocate of a "shareholder- or owner-centered" governance system. There is widening acceptance of the idea of inclusion of stakeholders in the governance structure, but without any solid theoretical foundation. Questions about why a stakeholder should be part of the governance system and who should be qualified to be a stakeholder are debated. In this respect, an understanding of property rights and contracts in the Islamic economic system provides convincing arguments for recognizing and protecting the rights of stakeholders.

A governance model in an Islamic financial system is of a stakeholders-based incentive system through active participation of public policy institutions, regulatory and supervisory authorities, and Shari'ah authorities. All of these institutions collectively monitor the performance of the firm and its faithfulness and commitment to explicit as well as implicit contracts that protect the interests of all stakeholders without violating anyone's property rights. This structure and process of governance incorporates legitimate rights and claims of stakeholders whenever a stakeholder's rights are "at risk" due to the actions and activities of the firm. This does not in any way negate or undermine the rights of shareholders to maximize profits, but this objective function is made subject to constraints to protect the rights of stakeholders through shareholders or their agents' (or firm's) explicit or implicit contracts.

## 3.2. The Role of Shari'ah Boards as an Organ of Governance

The concept of Shari'ah boards is unique to IFIs. The board consists of Shari'ah scholars who oversee and monitor the activities of a financial institution to ensure compliance with the principles of Shari'ah. Shari'ah boards take on a major responsibility and serve as organs

of governance, as they are the protectors of the rights of investors and entrepreneurs who have put their faith and trust in the financial institution to perform economic activities according to their beliefs.

The role of Shari'ah boards in sound governance is also critical - especially regarding consistent application. It is a common practice in the current governance structure of IFIs to maintain a Shari'ah board or Shari'ah advisor for each institution that not only monitors and ensures Shari'ah compliance but also issues the authoritative opinions or proclamations (fatawa) that the institution should follow in its operations. This latter practice leads to inefficient decision making due to duplication of effort, lack of standardization, and lack of competent Shari'ah experts. Instead, a system-wide board of knowledgeable religious scholars who are also specialized by training in Islamic economic and financial principles will be more efficient and will lead to optimal governance structures. This structure has been adopted in countries such as Malaysia and Sudan. According to this structure, a group of scholars and experts in finance, banking, economics, and accounting may be formed to constitute a highly competent system-wide or national Shari'ah board. Such a board could work closely with the regulators and supervisors to ensure that effective monitoring and supervisory controls are devised to protect the rights of all stakeholders according to the spirit of Islam. It will be the board's responsibility to ensure that compliance with the monitoring system will protect the rights of those stakeholders with whom the financial institution has "explicit" or "implicit" contracts. This structure of governance with a system-wide religious board will be more efficient and cost-effective for the following reasons:

- Each stakeholder will not be required to duplicate monitoring.
- Each institution will not be required to maintain its own fatwa-issuing board.
- The fatwa-issuing board will consist of experts knowledgeable in Shari'ah as well as finance.
- There will be uniformity of expected behavior, which will set the standards to be followed by individual institutions.

## 3.3. Investment Account Holders as Stakeholders

Investment account holders (IAHs) are like quasi-equity holders but without any participation in the governance of the financial institutions. As a result, IAHs do not have any direct recourse to protection of their rights. Since they do not have any participation in the governance mechanism, they are at the mercy of public policy makers, regulators, and Shari'ah boards. There should be a way to devise a transparent and efficient governance arrangement to include and protect the rights of IAHs. Such an arrangement (a Governance Committee as part of the governance structure of the institution with a specific role to safeguard the interests of IAHs) is suggested in the Islamic Financial Services Board's proposed Standard on Corporate Governance, issued as an Exposure Draft.

## 3.4. Financial Institutions as Stakeholders

Islamic financial institutions carry assets that are based on partnership contracts of *mudarabah* and *musharakah*. This creates a situation where financial institutions themselves become a stakeholder in businesses to which they provide financing. This is similar to the "insider" system of governance, as in the German model of banking where bankers may also be represented on the board of directors. Currently, not much attention is paid to this aspect, but it does impose an additional governance burden on the financial institutions as well as on the regulators.

#### 3.5. Governance of Reserves

Maintaining reserves to smooth income distributed to IAHs over periods of time is becoming a common practice. The objective of such a profit equalization reserve (PER) is to hedge against future low income distributions by keeping a portion of current profits to pay out to IAHs in the future.5 Whereas this practice is in alignment with prudent risk management, it raises a governance issue that needs attention. First, limited disclosure of such reserves and their use makes IAHs uneasy. Second, IAHs lack the rights to influence the use of such reserves and to verify the exposure of overall investments. Third, an investment account holder with long-term investment objectives might be comfortable with the practice of retaining profits earned in reserves, but other investors might feel that they would rather have profits paid out as they are earned, even if this means that the payout varies from period to period and may sometimes be zero. Finally, the latter attitude is all the more likely, since Islamic banks require IAHs to waive their rights to these reserves. For example, the terms and conditions of the Islamic Bank of Britain state: "You (the investment account holders) authorize us to deduct from net income your profit stabilization reserve contribution for payment into the profit stabilization reserve account. Upon such deduction you agree that you relinquish any right you may have to the monies in the profit stabilization reserve account." Islamic financial institutions should standardize their practice in respect of such reserves, and the rights of IAHs to these reserves should be clearly stated and explained to the depositors. One suggestion is that deduction from the profits belonging to IAHs should apply only to long-term depositors, who are more likely to be exposed, and not to every depositor, including short-term depositors who are not exposed to such risk.

#### 4. TRANSPARENCY

## 4.1. Transparency and Appropriate Information Flows Internally and to the Public

Over the past decade, the issues of transparency and accountability have been increasingly and strongly debated as part of economic policy discussions. Policy makers have long been accustomed to secrecy, which has been viewed as a necessary ingredient for the exercise of power; it also has the added benefit of hiding the incompetence of policy makers. However, secrecy also hinders the emergence of the desired effects of policies. The changed world economy and financial flows, which have entailed increasing internationalization and interdependence, have placed the issue of openness at the forefront of economic policy making. There is growing recognition on the part of national governments, including central banks, that transparency improves the predictability, and therefore the efficiency, of policy decisions.

"Transparency" refers to the principle of creating an environment where information on existing conditions, decisions, and actions is made accessible, visible, and understandable to all market participants. "Disclosure" refers more specifically to the process and methodology of providing the information and of making policy decisions known through timely dissemination and openness. "Accountability" refers to the need for market participants, including the relevant authorities, to justify their actions and policies and accept responsibility for both decisions and results.

In part, the case for greater transparency and accountability rests on the need for private-sector agents to understand and accept policy decisions that affect their behavior. Greater transparency improves economic decisions taken by other agents in the economy. Transparency is also a way to foster accountability, internal discipline, and better governance, while both transparency and accountability improve the quality of decision making in policy-oriented institutions. Such institutions – as well as other institutions that rely on them to make decisions – should be required to maintain transparency. If actions and decisions are visible and understandable, monitoring costs can be lowered. In addition, the general public is more able to monitor public-sector institutions, shareholders and employees have a better view of corporate management, creditors monitor borrowers more adequately, and depositors are able to keep an eye on banks. Poor decisions therefore do not go unnoticed or unquestioned.

Transparency and accountability are mutually reinforcing. Transparency enhances accountability by facilitating monitoring, while accountability enhances transparency by providing an incentive to agents to ensure that their actions are properly disseminated and understood. Greater transparency reduces the tendency of markets to place undue emphasis on positive or negative news and thus reduces volatility in financial markets. Taken together, transparency and accountability can also impose discipline that improves the quality of decision making in the public sector. This can result in more efficient policies by improving the private sector's understanding of how policy makers may react to events in the future.

## 4.2. What Transparency Cannot Ensure

Transparency and accountability are not ends in and of themselves, nor are they panaceas to solve all problems. They are instead designed to assist in increasing economic performance and may improve the working of international financial markets by enhancing the quality of decision making and risk management among market participants. In particular, transparency does not change the nature of banking or the risks inherent in financial systems. While it cannot prevent financial crises, it may moderate the responses of market participants to bad news. Transparency also helps market participants to anticipate and assess negative information, and thereby it mitigates panic and contagion.

The public disclosure of information is predicated on the existence of high-quality accounting standards and adequate disclosure methodology. The process normally involves publication of relevant qualitative and quantitative information in annual financial reports, which are often supplemented by biannual or quarterly financial statements and other important information. Because the provision of information can be expensive, its usefulness for the public should be weighed against the cost when disclosure requirements are determined.

## 4.3. Transparency in Financial Statements

The objective of financial statements is generally accepted to provide information about an entity's financial position (balance sheet), performance (income statement), changes in financial position (cash flow statement), and significant risk exposures and risk management practices<sup>6</sup> to the entity's stakeholders. The transparency of financial statements is secured through full disclosure and by providing fair presentation of the information necessary for making economic decisions to a wide range of users. In the context of public disclosure, financial statements should be easy to interpret.

As can be expected, specific disclosure requirements vary among regulators. Nonetheless, there are certain key principles whereby standards should be evaluated, according to a report submitted to the G7 Finance Ministers and Central Bank Governors. These key principles are summarized in Exhibit 2.5.

### 4.4. Transparency and Islamic Financial Institutions

Islamic financial institutions have made considerable efforts to improve the level of transparency and the quality of information disclosure in the market in recent years. However, there are still several areas where transparency is required to be enhanced. Some transparency-related issues are discussed below.

### Disclosure practices

Analysts often have difficulty in collecting useful information regarding IFIs. One factor contributing to this problem is the lack of uniform reporting standards by the financial institutions. For example, a recent study points out that a cursory survey of a sample of nine Islamic banks for which balance sheet data were easily available revealed that one bank did not provide sufficient details as to the division of equity and deposits, while the remaining eight banks provided a satisfactory division of equity and deposits. However, only five of those eight banks provided a detailed breakdown of the deposit types they offer; the remaining three clubbed different types of deposits together. Out

#### **EXHIBIT 2.5** Criteria for evaluating accounting standards

Effective accounting standards should satisfy three general criteria:

Accounting standards should contribute to – or at least be consistent with (and not hamper) – sound risk management and control practices in banks. They should also provide a prudent and reliable framework for the generation of high-quality accounting information in banks.

Accounting standards should facilitate market discipline by promoting transparent reporting of banks' financial position and performance, risk exposures, and risk management activities.

Accounting standards should facilitate and not constrain the effective supervision of banks.

#### In addition to the general criteria:

Disclosure should be sufficiently comprehensive for an assessment of a bank's financial position and performance, risk exposures, and risk management activities.

International accounting standards should be suitable for implementation not only in the most advanced financial markets but also in emerging markets.

There are also certain specific criteria that underpin high-quality accounting:

- Accounting principles should generate relevant and meaningful accounting information.
- Accounting principles should generate prodent, realistic, and reliable measurements
  of financial position and performance.
- Accounting principles should generate consistent measurements of similar or related items.

In addition, there are certain internationally accepted criteria for accounting standards: Accounting standards should not only have a sound theoretical foundation, but also be workable in practice.

Accounting standards should not be overly complex in relation to the issue addressed. Accounting standards should be sufficiently precise to ensure consistent application. Accounting standards should not allow alternative treatments. When alternative

treatments are permitted, or judgments are necessary in applying accounting principles, balanced disclosures should be required.

Source: Basel Committee on Banking Supervision: Report to G7 Finance Ministers and Central Bank Governors on International Accounting Standards, April 2000.

of these three deposit types, two made no specific reference to special investment accounts; the third made no distinction between demand and saving deposits.

The disclosure practices of Islamic banks are highly dispersed, and the supervisor's authority to impose disclosure norms is also highly varied. Exhibit 2.6 shows examples of the disclosure practices of some Islamic banks.

#### Financial information infrastructure

The collection and dissemination of financially relevant information and credit ratings needs significant improvement. However, it requires an institutional infrastructure that facilitates the production of accurate financial information, the development of agents that can

EXHIBIT 2.6 Disclosure practices of Islamic banks

Disclosure item	Practice
Deposit composition: Share of investment deposits to total deposits	Generally disclosed, ranging from 0% to 95%, with some banks (36%) reporting no investment deposits.
Return on restricted investment deposits	Very few (only one bank in the sample) disclose this
Risk management framework and practices	Disclosures are presented at a very general level; occasionally mentioned the existence of specific committees, such as ALM committee.
Value-at-risk (VaR)	None disclose this; one bank reported using VaR.
Large exposures	Very few banks (6%) disclose this.

Source: Sundararajan (2004).

interpret and disseminate it, as well as arrangements to protect its integrity. Considering that reliable and timely information is more critical for a system such as the Islamic financial system, which is supposed to take partnership positions, the current level of financial information infrastructure is not satisfactory. The existing limited infrastructure reduces the role that information flows may play in promoting competition and market activities that would induce managers to adopt sound corporate governance practices.

#### Demarcation of equity and depositors' funds

As mentioned earlier, an Islamic bank is a hybrid of the commercial and investment types of bank, more akin to a universal bank; but, unlike conventional universal banks, Islamic banks do not erect firewalls to separate – legally, financially, and managerially – their investment and commercial banking services. As a result, investment accounts' funds are not "ring-fenced" from others' funds, including the equity holders'. This commingling of funds is of concern to all stakeholders, since it becomes difficult to identify the sources of funds invested when the time comes to distribute profits and losses.

## Transparency in Shari'ah rulings

A transparent financial institution would ideally reveal the duties, decision making, competence, and composition of the Shari'ah board, as well as publish all fatawa issued by the board. This would strengthen stakeholders' confidence in the credibility of the Shari'ah board's assessments. In addition, public disclosure would provide a

venue for educating the public, thus paving the way for a larger role for market discipline with respect to *Shari'ah* compliance. Again, this aspect of transparency is missing from the market. Often the annual reports of a *Shari'ah* board are not readily available to the public, and other relevant information regarding *fatawa* by a *Shari'ah* board is not made available.

#### Lack of quantitative methods

The current AAOIFI standards and the supervisory disclosure rules do not cover the quantitative risk measures such as probability of default, value-at-risk (VaR), and so on. Sundararajan (2004) has suggested several quantitative methods for risk measurement. For example, similar to the idea of VaR, the risk of the investors/depositors can be quantified by a measure of profit-at-risk (PaR) based on the historical profits and the volatility of returns.7 The PaR measure can have multiple uses. First, it can provide an indication of the level of volatility in the expected profits of investors/depositors. Second, it can become handy in determining the level of income-smoothing reserves - profit equalization reserves - maintained by a majority of the IFIs to mitigate displaced commercial risk. The correlation between PER and the assets return could, therefore, be an indicator of "displaced commercial risk." Third, a PaR model can also be applied to individual business lines within the bank, such as the case of specific portfolios linked to restricted investment deposits to determine the level of risk. Application of quantitative models such as PaR can help management with their decision making regarding the level of PER and can offer transparency to investors about the volatility of profits, (See Chapter 3 for a detailed description of a PaR model.)

In addition, the application of financial modeling to the measurement of assets/liabilities risks is very limited. The use of quantitative methods can enhance the financial disclosures due to the enhanced measurement of risk exposures, especially in the area of credit and equity risk.

#### 5. CONCLUDING REMARKS

Given the special nature of financial intermediation of Islamic financial institutions with a "pass-through" mechanism, one might ask whether any special risk management approaches should be necessary. The answer must be a resounding "no" – it is not the risk management

itself that will differ from conventional banking practices, but the analysis and identification of the risk environment. In addition, it is not the theoretical framework that is vulnerable to additional risk; the existence of certain practices changes the risk landscape.

It was argued in this chapter that the balance sheet has to be structured in such a manner as to facilitate the identification of risk – to ensure that the risks and risk bearers become transparent to the reader of a financial statement. If funding is divided into risk-based buckets (see Exhibit 2.3), liquidity and agency/principal relationships are immediately clear. Likewise, a clear grouping of the lending or investment products into risk and risk-bearing buckets will further enhance the identification and management of risk – without a detailed knowledge of the subtle nuances of the actual products and their variants offered by IFIs.

It is further argued that the governance issues of IFIs need special attention. The inclusion and protection of the rights of all stakeholders in the governance process are critical elements. Van Greuning and Bratanovic (2003) summarized the supplementary role of each key player in the governance by arguing:

... To the extent that any key player does not, or is not expected to, fulfill its function in the risk management chain, other key players have to compensate for the gap created by enhancing their own role. More often than not, it is the bank supervisor who has to step into the vacuum created by the failure of certain players...

In the context of the corporate governance of Islamic financial institutions, the above quotation can be adapted to place the emphasis on the role of Shari'ah boards as compensating for regulatory and other governance gaps. As stated earlier, Shari'ah boards carry the trust of the investors/depositors as well as of the users of the funds to ensure that the institution is fully compliant with the Shari'ah in all its activities, whether the customer is an investor/depositor or an entrepreneur who wishes to engage in Shari'ah-compliant financing. They therefore have a great and grave responsibility to protect the rights of all stakeholders according to the principles of Shari'ah. This grave burden arises from the fundamental principles implicit in Islamic economics – that of a Higher Authority which governs the dealings of men, and the responsibility of all who base their business on the commands of such Authority to comply with higher standards, moral principles, and integrity than is often found in the secular business

world. The drive to preserve property rights and commitment to contracts will eventually develop an environment of "trust" as well as of transparency, thus reducing the need for an extensive governance structure.

Finally, a consistent risk-based framework for the transparent presentation of IFI financial statements should therefore be the goal of all parties interested in promoting the growth of a stable global Islamic financial system where risks are clarified, accountability is accepted, and the bearers of risk understand the nature and extent of their exposure.

#### **ENDNOTES**

- \* The authors are Senior Advisor and Principal Financial Officer, respectively, at the World Bank Treasury, Washington, D.C. The views expressed in this chapter are those of the authors and do not reflect the views of the World Bank Group and its executive directors.
- In some jurisdictions, such as the United Kingdom, the word "deposit" connotes an interest-bearing debt instrument. Islamic banks obviously cannot be "depositaccepting" in this sense.
- <sup>2</sup> Data were collected from the 2003 annual reports of the following banks: Kuwait Finance House, AlBaraka, Al-Tawfeek, Dubai Islamic Bank, Al Rajhi, and National Bank of Sharjah.
- <sup>a</sup> The failure of Savings and Loans companies in the United States during the 1980s is a classic example of bank failures due to a mismatch between assets and liabilities.
- 4 For a more detailed analysis, see Iqbal and Mirakhor (2004).
- Sistamic banks also typically maintain an Investment Risk Reserve (IRR) constituted entirely out of appropriations from the IAHs' share of profit. This reserve, unlike the PER, may be used to offset losses. The above reservations about the use of the PER are relevant also to the IRR.
- <sup>6</sup> The International Accounting Standards Board has recently issued International Financial Reporting Standard No. 7, Financial Instruments: Disclosure (IFRS 7), which requires a comprehensive set of disclosures concerning risks associated with holding financial instruments. This standard is particularly relevant for banks, and was developed in the light of comments from the Basel Committee on Banking Supervision.
- <sup>7</sup> The PaR model assumes normal distribution and can be calculated as being equal to Za\*σρ\*√T, where Za = is the constant that gives the appropriate one-tailed confidence interval with a probability of 1-α for the standard normal distribution (e.g. Z\_01 = 2.33 for a 99% confidence interval); T = the holding period or maturity of investment account as a fraction of a month; and σp = the standard deviation of the monthly profit as a percentage of assets.

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## Risk Characteristics of Islamic Products: Implications for Risk Measurement and Supervision

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#### 1. INTRODUCTION

This chapter discusses risk characteristics of various Islamic finance products and key issues in the measurement and control of risks in Islamic financial services institutions. In particular, the chapter highlights the role of risk sharing in Islamic finance, and the implications of profit-sharing investment accounts (PSIA, or "investment accounts") for risk measurement, risk management, capital adequacy, and supervision. Empirical evidence suggests that the sharing of risks with PSIA is fairly limited in practice, although, in principle, well-designed risk (and return) sharing arrangements with PSIA can serve as a powerful risk mitigant in Islamic finance. Supervisory authorities can provide strong incentives for effective and transparent risk sharing; and the associated product innovations. The scope of supervisory intervention and a value-at-risk (VaR) methodology for measuring these risks are discussed.

A key principle underlying the design of Islamic financial products and services is the notion that mutual risk sharing (for example, between banks and entrepreneurs, or between banks and depositors) is a viable alternative to interest-based financing, which is prohibited in Islamic finance. Islamic financial products and institutions offering Islamic financial services (IIFS) face a unique mix of risks and risk-sharing arrangements that arise from the contractual design of instruments based on *Shari'ah* principles, and the overall legal, governance, and liquidity infrastructure governing Islamic finance.

Effective risk management, however, requires appropriate risk measurement that recognizes the specific mix of risk factors in Islamic financial contracts and the extent of risk sharing embedded in the contracts. The issues of risk measurement and disclosure are central to adapting the New Basel Capital Accord – International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II) – for both conventional and Islamic banks. Risk measurement is also crucial to an effective disclosure regime that can harness market forces to reinforce official supervision.

The purpose of this chapter is to review the risk characteristics – defined as the type and mix of risks and the arrangements to share risks – of Islamic products and the related issues in the measurement of risks in IIFS. In particular, the chapter analyzes the implications of profit-sharing investment accounts for risk measurement, risk management, capital adequacy, and supervision. Islamic banks in most countries offer two types of PSIAs: restricted and unrestricted, normally based on a mudarabah contract. The bank as mudarib is entitled to a pre-specified percentage share of the profits from the investment as a fee for fund management, but does not share in a loss except by not receiving any fee. There is thus, in principle, a considerable degree of risk sharing between the bank and the investment account holders (IAHs) with respect to the assets in which the PSIA are invested.

The restricted investment accounts are a type of collective investment scheme in which the bank as *mudarib* invests the funds of the IAH according to a restricted mandate that limits the asset allocation to a pre-specified category of assets. The unrestricted investment accounts are designed as a *Shari'ab*-compliant alternative to conventional interest-bearing deposit accounts; the IAH funds are invested at the bank's unrestricted discretion and are normally commingled for investment purposes with other funds such as the bank's own capital and current accounts. (The latter are a liability of the bank and do not share in profits.)

Available empirical evidence shows that in practice, because the product is intended to provide a Shari'ah-compliant alternative to conventional deposits, there is considerable smoothing of the profits paid out to unrestricted IAHs, and correspondingly reduced sharing of

risk between the bank and the holders of such investment accounts, with banks in fact bearing the majority of the risk despite wide divergences in risk. The extent of this *de facto* departure from the risk-sharing principle for unrestricted IAHs (referred to as displaced commercial risk, or DCR, following AAOIFI, 1999) varies between countries; in some countries, banks are expected – though not legally bound<sup>1</sup> – to bear virtually all of the asset risk, while in others it is simply a matter of competitive pressure. References to IAHs, investment accounts, or PSIA in the remainder of this chapter should be understood as being to unrestricted IAHs.<sup>2</sup>

This chapter proposes a specific approach to the issue of DCR by measuring the actual sharing of risks between shareholders and IAHs, based on value-at-risk methodology. The main conclusions of the chapter are as follows:

- Appropriate management of PSIA, with proper measurement, control, and disclosure of the extent of risk sharing with IAHs, can be a powerful risk mitigant in Islamic finance.
- Supervisory authorities can provide strong incentives for 2. effective overall risk management, and transparent risk sharing with PSIA, by (a) linking the treatment for capital adequacy purposes of the share of assets on the bank's balance sheer that is financed by PSIA to a supervisory review of bank policies for risk sharing; and (b) mandating the disclosure of risks borne by PSIA and of the DCR borne by the shareholders, as part of the requirements for deciding the amount of any capital charge to be applied to this share of assets - that is, the fraction of the PSIA share of riskweighted assets that could be excluded from the denominator of the bank's capital adequacy ratio (CAR). The evolving standards for capital adequacy, supervisory review, and transparency and market discipline are consistent with these proposals.

Several key conclusions and policy messages can be highlighted at the outset.

Effective risk management in IIFS (and a risk-focused supervisory review process) requires that a high priority be given to proper measurement and disclosure of:

- aggregate banking risks (to reflect the volatility of mudarabah profits accruing to IAHs)
- specific types of risks (to control effectively the extent of credit, market, operational, and liquidity risks)
- facility-specific risks (to properly price individual facilities by measuring the full range of risks embedded in each facility).
- The unique mix of risks in Islamic finance and the potential role
  of IAHs in sharing some of the risks call for a strong emphasis
  on proper risk measurement, and disclosure of both risks and
  risk management processes in IIFS.
- Progress in risk measurement, disclosure, and risk management will, however, require a multi-pronged effort:
  - to strengthen accounting standards and harmonize them with prudential standards
  - to initiate a systematic data compilation process to enable proper risk measurement, including through developing central credit and equity registries suitable for Islamic finance
  - to build a robust governance and creditor/investor rights infrastructure that would foster Islamic money and capital markets – based on innovative uses of asset securitization – as a foundation for effective on-balance sheet risk management, including through transparent apportioning of risks to IAHs
  - to foster this transformation of investment accounts into an effective component of risk management (in addition to collateral and guarantees) through product innovations supported by proper disclosure and reserving policies that make transparent the extent of risk being borne by the investment accounts, and the risk-return mix being offered.
  - to provide supervisory incentives for effective risk sharing with PSIA, by linking the capital adequacy treatment of PSIA to the extent of actual risks shared with PSIA, and by requiring adequate disclosure of these risks as a basis for "capital relief" (that is, the exclusion of part or all of risk-weighted PSIA-financed assets from the denominator of the CAR).

All this will set the stage for the eventual adoption of more advanced capital measurement approaches envisaged in Basel II and their adaptations for Islamic finance as outlined in the relevant Islamic Financial Services Board (IFSB) standards. The chapter highlights some of the measurement issues arising from the unique risk characteristics of Islamic finance contracts and policy considerations in promoting effective risk sharing between owners and investment accounts holders. A VaR methodology for measuring and monitoring such risk sharing is proposed.

#### 2. BACKGROUND

Recent work on risk issues in Islamic finance has stressed that features of IIFS, and the intermediation models that they follow, entail special risks that need to be recognized to help make risk management in Islamic banking truly effective. Karim (1996) and Hassan (2000) have noted that the traditional approach to capital adequacy and supervision based on the 1988 Basel Capital Accord - Basel I - did not adequately capture the varied risks in Islamic finance facilities. In a similar vein, recent studies in the Islamic Development Bank discuss the special risks in IIFS (Chapra and Khan, 2000; Khan and Ahmed, 2001). These studies survey the risk management practices of IIFS, and note that Basel II provides scope for proper recognition of risks in Islamic banking products - through a more risk-sensitive system for risk weighting of assets and stronger incentives for effective risk management. These studies also highlight a set of issues in Islamic jurisprudence ("fiah" issues) that need to be resolved to facilitate effective supervision and risk management. Implications of risk sharing with PSIA for the governance, financial reporting, and capital adequacy of Islamic banks are discussed in Al-Deehani, Karim, and Murinde (1999) and Archer and Karim (2002, 2004). A recent World Bank study (El-Hawary et al., 2004) considered the appropriate balance of prudential supervision and market discipline in Islamic finance, and the related implications for the organization of the industry. In parallel, recent studies from the International Monetary Fund focus on the financial stability implications of Islamic banks (Sundararajan and Errico, 2002; Marston and Sundararajan, 2003; Sundararajan, 2004). These studies also stress the importance of disclosure and market discipline in Islamic finance (see also Archer and Karim, 2005); they also note that in addition to the unique mix of risks, for a range of risks, Islamic banks may be more vulnerable than their conventional counterparts, owing in part to the inadequate financial infrastructure for Islamic banks, including missing instruments and markets, and a weak insolvency and creditor rights regime, factors that limit effective risk mitigation.

Therefore, systemic stability in financial systems with Islamic banks requires a multi-pronged strategy to bring about:

- · a suitable regulation and disclosure framework for IIFS
- a robust financial system infrastructure and adequate macroprudential surveillance in order to provide the preconditions for effective supervision and risk management
- strengthened internal controls and risk management processes within IIFS.

Accordingly, a comprehensive risk-based supervision framework is needed for IIFS, supported by a clear strategy to build up risk management processes at the level of the individual institutions, and robust legal, governance, and market infrastructure at the national and global levels. In recognition of this need, the international community has established the Islamic Financial Services Board, headquartered in Kuala Lumpur, Malaysia, to foster good regulatory and supervisory practices, help to develop uniform prudential standards, and to support good practices in risk management.<sup>8</sup>

The IFSB has advanced the work on the capital adequacy framework and risk management in IIFS, through the issuance of standards on these topics in December 2005 (see IFSB, 2005a, 2005b). In addition, work is under way (in various IFSB working groups and task forces) on corporate governance standards (the subject of an Exposure Draft issued in January 2006), on disclosure standards to promote transparency and market discipline, on standards for the supervisory review process, and on additional guidelines for the prudential and legal framework for Islamic banks. Recent discussions coordinated by the IFSB and the Islamic Development Bank have again reinforced the importance of building a robust financial infrastructure for Islamic finance – which constitutes the precondition – to support the sound functioning and effective supervision of Islamic banks.<sup>4</sup>

In particular, the effective supervision of Islamic banks requires that the three-pillar framework of Basel II and the language of risks it introduces be adapted appropriately to their operational characteristics. Key issues in the measurement and monitoring of specific risks and risk sharing in Islamic finance are first reviewed before considering policy implications.

#### 3. TYPES OF RISKS IN ISLAMIC FINANCE AND THEIR MEASUREMENT

A key feature of IIFS is the potential sharing of risks between IAHs who provide funds on a mudarabah basis, and the IIFS which invests these funds (often commingled with shareholders' and other funds) in various Islamic finance contracts that include murabahah, salam, mudarabah, musharakah, ijarah, istisna'a, and other Shari'ah-compatible financing arrangements, including sukuk. This section reviews the overall risks facing IIFS in light of its financing activities on the asset side, modalities of sharing these risks with fund providers, and the types of risks embedded in individual Islamic finance contracts on the asset side of IIFS.

#### 3.1. Mudarabah Risk

The way risks are shared between IAHs who invest on a mudarabah basis, and the bank as a mudarib, plays a crucial role in Islamic finance. The share of unrestricted investment accounts in the total deposits of Islamic banks varies considerably, from near zero (holding only demand and savings deposits) to over 80% in some banks (Exhibit 3.1). The implications of such PSIA for risk measurement, disclosures, and bank governance generally have been the topic of several studies (see Clode, 2002; AAOIFI, 1999; Archer and Karim, 2006). In this section, we will highlight specific risk measurement issues that need to be addressed in monitoring the risk-return tradeoff in PSIA. The focus is on the financial risks faced by the unrestricted investment accounts: for restricted investment accounts, the risks for banks and depositors are those attributable to the specific assets to which the investment account returns are linked, and the risk measurement issues discussed in this chapter can be readily applied to the relevant asset portfolio. Both restricted and unrestricted IAHs also face fiduciary risks - risks of negligence and misconduct - reflected in the quality of internal controls, corporate governance, and risk management processes of the IIFS acting as mudarib.

In its most general form, risk is uncertainty associated with a future outcome or event. To an IAH in an Islamic bank, the risk is the expected variance in the measure of profit distributions where

EXHIBIT 3.1 Disclosure practices of Islamic banks

Items of disclosure	Comments
Risk management framework and practices	Disclosures are presented at a very general level and occasionally mention the existence of specific committees, such as the ALM committee.
Classification of facilities by asset quality, and data on non-performing loans	All banks disclose classification of facilities by supervisory categories such as current, sub-standard, etc. Only some banks (30%) disclose non-performing loans. Only one bank mentioned the use of an internal rating system.
Specific provisions	Most banks (94%) disclose this as a total, Provisions as a percentage of assets varied from less than 1% to 6%. Only some banks (30%) disclose provisions classified by facilities.
Sectoral distribution of credit and connected exposures	Many banks (66%) disclose this.
Large exposures	Very few banks (6%) disclose this.
Capital adequacy	All banks disclose capital asset ratios – ranging from 2.5% to 38.4%, while many (66%) disclose regulatory capital to risk-weighted assets.
Value-at-risk	None disclose this; one bank reported using VAR.
Liquidity ratios	All banks disclose various liquid asset ratios. Ratio of liquid assets to short-term liabilities ranged from 13% to 144%.
Maturity gap	Many banks (64%) disclose gaps at various maturity buckets.
Deposit composition: Share of investment deposits to total deposits	Generally disclosed, ranging from 0% to 95%, and averaging 80%, with some banks (36%) reporting no investment deposits.
Composition of facilities: Share of equity-type assets to total assets	Generally disclosed. Share of equity varied from less than 1% to about 23%, with a significant year-to-year change in some banks.
Return on assets	Generally disclosed; large variation from 0.5% to 4.3%,
Return on equity	Generally disclosed; large variation from 0.7% to 58%.
Return on unrestricted investment deposits	All banks disclose this, with returns ranging from 1.45% to 16.35%, depending on country and bank.
Commodity inventories	Only some banks (30%) disclose this.
Return on restricted investment deposits	Very few (only one bank in the sample) disclose this.
Profit equalization reserves	Some banks (30%) disclose this.
Net open position in foreign exchange	Many banks (66%) disclose this; the ratio as a percentage of capital varied from 0% to 100%.
Foreign currency liabilities to total liabilities	Many banks (66%) disclose this; the ratio varied from 0% to $100\%$ .

EXHIBIT 3.1 (continued)

Items of disclosure	Comments
Net position in equities to capital	Generally disclosed, with the ratio ranging from 0% to 4%.
Gross income to assets	All banks disclose this; it varies from 1% to 8%.
Personnel expenses to total assets	All banks disclose this; it varies from 30% to 65%.
Operational expenses to total assets	All banks disclose this; it varies from less than 1% to 5%.

Source: Based on annual reports of 15 sample banks covering the years 2002 and 2003. Percentages of sample banks that disclose a particular item are shown in parentheses.

the profit is shared between the IAH and the bank. This variance could arise from a variety of both systemic and idiosyncratic (that is, bank-specific) factors. Actual risk in the investment account (that is, in the underlying investments) may be dampened in practice by the use of profit equalization reserves (PER), investment risk reserves (IRR), and by variations in the mudarib's share. The PER is used to reduce or eliminate the variability of profit payouts on investment deposits, to redistribute income over time, and to offer returns (payouts) that are aligned to market rates of return on conventional deposits or other benchmarks, without the need for the bank to forgo any of its mudarib share. In addition, banks may use the IRR to redistribute over time the incomes accrued to the investment accounts so as to maintain a payout when a periodic loss is incurred. Nevertheless, from an investor's point of view, the true risk of mudarabah investment in a bank can be measured by a simple profit-at-risk (PaR) measure. For example, the standard deviation of the periodic (for example, monthly or quarterly) profit payout5 as a percentage of assets, on, provides the basis for the simplest measure of the risks of holding an investment account after the application of the above methods of "smoothing," In banks that practice such smoothing, this risk will of course be lower than the risk of the underlying assets, measured based on the standard deviation of the unsmoothed profits. One issue is how important it is for IAHs to be aware of this underlying risk.

From a monthly time series of *mudarabah* profit payouts (as a share of assets), its variance (and the standard deviation  $\sigma_{\rm p}$ ) can be calculated, and, assuming normality, profit-at-risk can be calculated as:

$$PaR = Z\alpha \sigma_p \sqrt{T}$$

Where, as explained in Chapter 2:

Zα = the constant that gives the appropriate one-tailed confidence interval with a probability of 1 – α for the standard normal distribution (e.g. Z<sub>.01</sub> = 2.33 for a 99% confidence interval).

T = the holding period or maturity of the investment account as a fraction of a month.

Such aggregate PaR for a bank as a whole provides a first-cut estimate of risks attaching to profit payouts in unrestricted mudarabah accounts. Such risk calculations could also be applied to individual business units within the bank (also for specific portfolios linked to restricted IAHs). In addition, if specific risk factors that affect the variation in mudarabah profit payouts can be identified, this measure  $\sigma_p$  can be decomposed further in order to estimate the impact of individual risk factors, and this would help to refine the PaR calculation. In practice, however, profit equalization reserves and investment risk reserves are actively used by IIFS to smooth the return on investment accounts. As a result, risks in investment accounts are absorbed, in part, by banks themselves, in so far as the PER is strongly positively correlated with net return on assets (gross return on assets minus provisions for loan losses) - that is, PER is raised or lowered when the return on assets rises or falls, and hence the profit payout on the investment accounts is smoothed, and low or zero payouts are avoided except in the case of a loss when recourse is had to the IRR. Banks can also adjust their share of profits to maintain adequate returns to shareholders. As noted above, such absorption of risks by bank capital is referred to as "displaced commercial risk." The correlation between the movements on the PER and the asset return could, therefore, be viewed as an indicator of DCR. Thus, the precise relationship between the risk to IAHs and the aggregate risk for the bank as a whole arising from the variability of net return on assets (gross return net of specific provisions) depends upon the policies toward profit equalization reserves, investment risk reserves, and mudarib's share. These policies determine, in effect, the extent of risk sharing between investment accounts and bank capital. These relationships are discussed further in Section 4 of the chapter.

Against this background, the true risks borne by IAHs can be made transparent by disclosing the definition of *mudarabah* profits, the level and variations in these profits and in profit equalization reserves, as well as policies toward establishing PER<sup>6</sup> that will determine the variance in its movements as well as their correlation with the asset return. At the same time, transparency of internal controls and governance arrangements, including risk management processes, would also be important to provide assurances of integrity of IIFS as a *mudarib*. The measurement of such fiduciary risk could be subsumed under operational risk measurement, as discussed in Section 3.6 below.<sup>7</sup>

#### 3.2. Credit Risks in Sales-based Contracts

Murabahah and other sales-based facilities (istisna'a, salam, and so on) together with lease-based facilities (ijarah) dominate the asset side of Islamic banks, ranging from 80% to 100% of total facilities. Equity-type (profit- and loss-sharing musharakah or profit-sharing and loss-bearing mudarabah) facilities still constitute a negligible proportion of assets in most banks. Thus, credit risk in the normal sense – the risk of losses in the event of default of the borrower or in the event of a deterioration of the borrower's repayment capacity8 – is the most common source of risks in an Islamic bank, as in conventional banks.9 The methods of measurement of credit risks in conventional banks apply equally well to Islamic banks, with some allowance required to recognize the specific operational characteristics and risk-sharing conventions of Islamic financial contracts.

Credit risk can be measured based on both the traditional approach that assigns each counterparty into a rating class (each rating corresponding to a probability of default) as well as more advanced credit VaR methods discussed later in the section. The basic measurement principle under both these approaches is to estimate the expected loss on an exposure (or a portfolio of exposures) owing to specified credit events (default, rating downgrade, some non-performance of a specified covenant in the contract, and so on) and also to calibrate unexpected losses (losses that exceed a specified number of standard deviations from the mean) that might occur at some probability level. Expected losses are provisioned and regarded as an expense that is deducted from income, while unexpected losses (up to a tolerance level) are backed up by capital allocation. The risk weights attached to various exposures on the bank's asset side (in the New Basel Capital Accord, for example) in effect represent the bank's or supervisor's judgment on the unexpected losses on the exposures that should be absorbed by capital. The calculation of loss - both expected and unexpected - in an individual loan will require estimates of:

- probability of default (or probabilities of rating downgrades from one rating class to another)
  - potential credit exposures at default (or at the time of rating transition)
  - loss-given default (or reduction in the value of the asset following a rating transition).

Proper measurement of these three components of credit risk, and calculating unexpected losses, are the fundamental requirements of the New Basel Capital Accord (Basel II). Measurement of these components for the case of sales-based contracts – murabahah and salam – is discussed below.

The default could be defined in the same way as for conventional banks, based on the financial condition of the borrower and the number of days the contract is overdue. 10 Estimation of the probability of default is traditionally based on ex-ante assignment of ratings to counterparty exposures or a portfolio of exposures of a particular variety (such as all commodity Murabababs for a class of goods). A modern approach that can be used for larger listed companies is based on market information on equity prices. Observed market value of a firm's equity and estimated volatility of equity prices can be used to estimate the likelihood of default using the option pricing approach to bankruptcy prediction.11 In practice, various methods can be combined during the risk management process in order to arrive at a credit rating and the associated probability of default based on historical experience. The estimation of probabilities - or correct assignment of ratings - will, however, require historical data on loan structure and performance, borrower characteristics, and the broader industry and macroeconomic environment; and thus the ratings will change over time as financial conditions and environment change.

Losses will clearly depend upon the potential credit exposures at the time of default (exposure at default, or EAD). In general, exposure at default would be facility-specific, depending upon the extent of discretion that the borrower can exercise in drawing down lines of credit, prepaying already drawn accounts, or any specific events that affect the value of contingent claims (for example, guarantees to third parties). In murabahah and salam contracts, EAD in most cases would

simply be the nominal value of the contract. In long-term *ijarah* and *istisna'a* contracts, EAD will depend upon projected environmental factors that will be facility-specific.

Losses will ultimately depend upon the rate of recovery following default, or, in a mark-to-market model, the reduction in the value of the loan if ratings change, Loss-given default (LGD - that is, one minus recovery rate times EAD) is likely to depend upon ease of collecting on the collateral, the value of the collateral, the enforceability of guarantees, if any, and, most importantly, on the legal environment that determines creditors' rights and the features of insolvency regime. For example, the juristic rules for murabahah imply that "in case of insolvency, Ithel creditor should defer collection of the debt until he becomes solvent."12 The precise interpretation of such considerations would determine the length of time needed to recover overdue debt. In addition, there could be legal risks owing to difficulties in enforcing Islamic finance contracts in certain legal environments. 13 Moreover, the inability of Islamic banks to use penalty rates as a deterrent against late payments could create both a higher risk of default and longer delays in repayments.14 Finally, the limitations on eligible collateral under Islamic finance - or excessive reliance on commodities and cash collateral - may exacerbate credit risks generally, and reduce the potential recovery value of the loan if commodity collateral proves too volatile in value. For these reasons, LGD in murabahah facilities could be different, probably higher, than in conventional banks, thereby affecting the size of losses and capital at risk.

Given the estimates of probability of default (PD), or probabilities of transition from one rating class to another (transition matrix), and the estimated LGD (or change in value of the loan for any given transition from one rating class to another), the expected and unexpected losses can be readily computed. For example, in the Default Model, expected loss (EL) is given by:

$$EL = PD \times LGD \times EAD$$

where LGD is expressed as a proportion of exposure at default.

The unexpected loss (UL) can be calculated based on assumptions on the distribution of default and recoveries. Assuming that LGD is fixed, and that borrowers either default or do not default, the default rate is binomially distributed, and the standard deviation of the default rate is:

$$\sigma = \sqrt{[PD(1 - PD)]}$$

Therefore, a measure of UL on the loan is:

$$UL = Z_{\alpha} \sqrt{[PD(1 - PD)]} \times LGD \times EAD$$

 $Z_{\alpha}$  above is a multiple (for example, a normal deviate) that limits the probability of unexpected losses to a specified level. This is the value-at-risk for this credit facility, representing the amount of capital needed to cover the unexpected loss in this exposure. In the case of a mark-to-market model, the calculation of EL and UL takes into account the prospects for both upgrades as well as downgrades of the loan, and considers the change in value of the loan for each possible change in the rating of a facility from its current level, and the corresponding probability of rating transition. <sup>15</sup>

While similar considerations apply in the case of salam contracts for calculating counterparty credit risk, there is an additional commodity price risk embedded in these contracts that should be added to the credit risk. The commodity price risk will arise even when the counterparty does not default, and when there is default (for example, delivery of a substandard good, delayed delivery of a good, etc.) the commodity price risk - taking into account any offsetting parallel salam positions - could be included as part of the LGD. Thus, potential loss in a salam contract is the sum of the loss due to credit risk and the loss due to commodity price risk, assuming that delivery takes place according to the contract (that is, there is no credit risk loss). In addition, there could be a correlation between these two types of risks (for example, due to common factors such as drought that could affect both commodity price risk and counterparty credit risk), which could be estimated based on historical data but is ignored for the time being for simplicity. In the absence of liquid commodity markets as well as Shari'ah-compatible hedging products to mitigate price risks, commodity price risk can be measured by calculating the value-at-risk of commodity exposures in different maturity buckets using historical data on prices. While commodity exposures can be treated as part of market risk measurement for capital allocation purposes, it is important to compute this market risk separately for each salam contract or for a portfolio of salam contracts and to add it to the credit risk so that the full risk in each contract (or portfolio of contracts) can be properly measured and taken into account in the pricing of the contract (or the facility). Also, the estimated commodity price risk should be monitored regularly, as price volatility could

change over time due to shifts in macroeconomic and market-specific conditions.

Finally, credit risk of a portfolio of exposures and facilities could be lower or higher depending upon the extent of diversification or concentration in specific credit categories. The credit risk measurement can take into account the benefits of diversification by computing the joint distribution of default events based on correlations between different classes and segments of the portfolio - that is, correlations between defaults among counterparties and the joint probability of default of any pair or group of counterparties can be estimated. This can form the basis for valuing the loan portfolio and computing the expected loss in the loan portfolio as a whole, based on the joint distribution of components of the portfolio. In some models, default rates and transition probabilities can be made a function of macroeconomic variables. The probability distribution of gains and losses of the loan portfolio, or the loan facility, can then be used to compute both expected and unexpected losses (at a given probability level). In case of loans to a diversified group of individuals and small businesses, with standard instalments and commodity leases, supervisors and banks might treat the class of loans as a retail exposure with a smaller risk weight (reflecting lower value-at-risk due to diversification effects). At the same time, credit concentrations by sectors and rating classes should be monitored as alternative indicators of credit risk.

#### 3.3. Equity Risks in Mudarabah and Musharakah Facilities

These are equity-type facilities, typically a very small share of total assets in part reflecting the significant investment risks that they carry. In a sample of Islamic banks, the share of mudarabah and musharakah facilities and traded equities varied from 0% to 24%, with a median share of about 3%. The possible unexpected losses in such equity-type contracts will depend upon the functions of the underlying enterprise or venture in which the bank acquires an equity exposure. <sup>16</sup> In a venture formed for trading in commodities or foreign exchange, the equity position risk arises from the risk of underlying transactions by the venture. A measure of the potential loss in equity exposures in business enterprises that are not traded can be derived based on the standard recommended in Basel II (paragraph 350) and the IFSB Standard for "equity position risk in the banking book." <sup>17</sup> In addition, a mudarabah facility may need to be assigned

an additional UL due to operational risk factors, with the extent of operational risk adjustment depending on the quality of internal control systems to monitor *mudarabah* facilities on the asset side. High-quality monitoring would be very important in Islamic banks, since the finance provider cannot interfere in the management of the project funded on a *mudarabah* basis. In the case of *musharakah*, the need for operational risk adjustment may be less, in so far as the bank exercises some management control. If the bank's equity interest in a counterparty is based on regular cash flow and not capital gains, and is of a long-term nature linked to customer relationship, a different supervisory treatment and a lower LGD could be used. If, however, equity interest is relatively short term, relies on capital gains (for example, traded equity), a VaR approach, subject to a minimum risk weight of 300%, could be used to measure capital at risk (as proposed in Basel II).

#### 3.4. Market Risks and Rate of Return Risks

The techniques of market risk measurement in the trading books of Islamic banks should be broadly identical to those in conventional banks. The trading book, in Islamic banks, however, is likely to be limited to traded equities, commodities, foreign exchange positions, and, increasingly, various forms of sukuk. A large share of assets of Islamic banks also consists of cash and other liquid assets, with such short-term assets typically exceeding short-term liabilities and amounts that IAHs are entitled to withdraw at short notice by a large margin, in part reflecting the limited availability of Shari'ah-compatible money market instruments. Against this background, exposure to various forms of market risk can be measured by the traditional exposure indicators, such as:

- · net open position in foreign exchange
- · net position in traded equities
- · net position in commodities
- · rate-of-return gap measures by currency of denomination
- various duration measures of assets and liabilities in the trading book.

Most Islamic banks compute and often disclose liquidity gap measures - the gap between assets and liabilities at various maturity buckets - and hence the computation of the rate-of-return or re-pricing gap should be fairly straightforward. More accurate duration gap measures may also be available in some banks. Gap and duration measures, and their availability in banking statistics, are discussed in the Compilation Guide for Financial Soundness Indicators (IMF, 2004). Duration measures are important indicators of financial soundness, but they are not readily available in many banking systems. Baldwin (2002) discusses duration measures in the context of Islamic banking. The impact on earnings of a change in exchange rate, equity price, commodity price, or rates of return can be directly obtained by multiplying the appropriate gap or other exposure indicators by the corresponding price change. Such a simple approach will not, however, suffice for computing the impact of changes in interest rates on equity-type exposures of fixed maturity (such as mudarabah and musharakah). The impact of changes in the rates of return on the expected rate of profits (that is, mudarabah and musharakah income) would need first to be computed, or equivalently the equity exposures should be adjusted by a multiplicative factor (which a supervisor can specify) before computing gaps in each maturity bucket.

Such gap measures may not, however, capture the maximum losses that could occur (at some probability level), particularly in Islamic banks. They do not properly recognize other market-related risks arising from changes in the spread over benchmark rates, or twists in the yield curve, or shifts in market volatility, which could affect potential losses. For these reasons, market risk is commonly measured by various VaR measures. This is particularly important, given the likely importance of equities and commodities in Islamic bank balance sheets, which have potential to cause large losses. For example, for both equities and commodities, VaR based on a 99% confidence level (one-sided confidence interval) could be computed. VaR could be based on quarterly equity returns (mudarabah or musharakah profit rate) net of a risk-free rate, 18 or quarterly or monthly changes in commodity prices.

In most Islamic banks, the rate-of-return risk in the banking book is likely to be much more important than market risk in the trading book. The rate-of-return gap and duration gap applied to the banking book would provide measures of exposures to changes in benchmark rates of return, and of the impact of these changes on the present value of bank earnings. For example, a simple stress test of applying a 1 percentage point increase in rates of return on both

assets and liabilities maturing—or being reprised—at various maturity buckets would yield a measure of potential loss (or gain) due to a uniform shift in term structure of rate of return.<sup>20</sup>

Another important source of risk is the possible loss due to a change in the margin between domestic rates of return and the benchmark rates of return (such as LIBOR), which may not be closely linked to the domestic return. Many Islamic banks use an external benchmark such as LIBOR to price the mark-up in *murabahah* contracts, in part reflecting the lack of a reliable domestic benchmark rate of return. If domestic monetary conditions change, requiring adjustments in returns on deposits and loans, but the margin between the external benchmark and domestic rates of return shifts, there could be an impact on asset returns. This is a form of "basis risk" that should be taken into account in computing the rate-of-return risk in the banking book (and also market risks). The existence of this basis risk highlights the importance of developing a domestic rate-of-return benchmark so that both deposits and assets can be aligned to similar benchmarks.

## 3.5. Liquidity Risk

This risk is interpreted in numerous ways, such as extreme liquidity, availability of liquid assets to meet liabilities, and the ability to raise funds at normal cost. This is a significant risk in Islamic banks, owing to the limited availability of Shari'ah-compatible money market instruments and lender of last resort (LOLR) facilities. A standard measure of liquidity risk is the liquidity gap for each maturity bucket and in each currency. The share of liquid assets to total assets or to liquid liabilities is also a commonly used measure. While the availability of core deposits (current accounts and investment accounts) which are rolled over, and not volatile, provides a significant cushion for most Islamic banks, the remaining volatile deposits cannot be readily matched with short-term liquid assets, other than cash and other low-yielding assets.

In addition, specific aspects of Islamic contracts could increase the potential for liquidity problems in Islamic banks. These factors include: cancellation risks in *murabahah*, the *Shari'ah* requirement to sell *murabahah* contracts only at par, thereby limiting the scope for secondary markets for sale-based contracts, the illiquidity of commodity markets, and prohibition of secondary trading of *salam* or *istisna'a* contracts (see Ali, 2004).

## 3.6. Operational Risk

This is defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This includes legal risk, but excludes strategic and reputation risk,"21 Such risks are likely to be significant in Islamic banks, due to specific contractual features and the general legal environment. Specific aspects that could raise operational risks in Islamic banks include the following: (1) the cancellation risks in non-binding murabahah and istisna'a contracts; (2) problems in internal control systems to detect and manage potential problems in operational processes and back-office functions; (3) technical risks of various sorts; (4) the potential difficulties in enforcing Islamic finance contracts in a broader legal environment: (5) the risk of non-compliance with Shari'ah requirements that may impact on permissible income; (6) the risk of "misconduct and negligence" which would result in mudarababbased PSIA becoming a liability of the Islamic bank, with consequent capital adequacy and solvency implications; (7) the need to maintain and manage commodity inventories, often in illiquid markets; and (8) the potential costs and risks in monitoring equity-type contracts and the associated legal risks. In addition, the increasing use of structured finance transactions - specifically, securitization of assets originated by banks - could expose banks to legal risks.

The principle of setting a capital requirement in the form of a risk-weighted-asset equivalent for operational risk is subject to discussion, since operational risks pertain to a bank's systems and procedures, not to its assets or balance sheet positions as such. It has to be said that the treatment of this risk in relation to capital requirements was a new departure in Basel II. The three methods based on "gross income" are undoubtedly crude when applied to conventional banks; in the case of Islamic banks, this is true a fortiori. The use of gross income as the basic indicator for operational risk measurement could be misleading in Islamic banks, in so far as a large volume of transactions in commodities and the use of structured finance raise operational exposures that will not be captured by gross income. The standardized approach that allows for different business lines is better suited, but still requires adaptation to the needs of Islamic banks. In particular, agency services under mudarabah, the associated risks due to potential misconduct and negligence, and operational risks in commodity inventory management, all need to be explicitly considered for operational risk measurement. For a further

discussion of this issue, see Jackson-Moore (2006), Chapter 11 in this volume.

## 3.7. Mix of Risks by Type of Products

The above review of risk characteristics of Islamic products by type of risk poses a challenging issue of how to recognize the specific bundling of risks in individual Islamic finance products, and the associated correlation among risks. Monitoring the mix of risks for each facility in a centralized and integrated manner is key to pricing the risks. First, all Islamic finance contracts – whether sales-based, leased asset-based, or equity-based – in light of the associated operations in commodities, and the need to monitor or intervene in governance and controls of counterparties in equity-based contracts, are exposed to a mixture of credit and operational risks. In addition, murababah and salam contracts will also face commodity price risk; holdings of sukuk, for instance, will carry a mixture of credit, market, and operational risks. Also, the mix of risks will vary according to the stage of contract execution, as recognized in IFSB (2006b).

## 4. OVERALL RISK OF AN ISLAMIC BANK AND APPROACHES TO RISK MITIGATION

Potential losses due to each category of risk could be quantified and aggregated to derive the total impact of the different risks, and to examine the adequacy of capital to absorb the risks. However, it is unlikely that the unexpected losses will exceed their upper bounds at the same time for different types of risk, and the arithmetic total of individual risks will be an overestimate of the aggregate VaR for the bank as a whole. Such an aggregate VaR is, however, important for informing unrestricted IAHs of Islamic banks, who are expected to share in the overall risks. An overall risk measure could be obtained from historical distribution of earnings, and calculating earnings volatility, as already discussed.

A key issue for Islamic banks is to manage the risk-sharing properties of investment accounts – both restricted and unrestricted – in order to mitigate some of the risks to shareholders. Thus, in addition to collateral, guarantees, and other traditional risk mitigants, the management of the risk-return mix, particularly of unrestricted IAHs, could be used as a key tool of risk management. Appropriate policies toward profit equalization reserves (and, possibly,

investment risk reserves), coupled with appropriate pricing of investment accounts to match the underlying risks, would improve the extent of overall risk sharing by these accounts. Under current practices, reserves are passively adjusted to provide a stable return to unrestricted IAHs, effectively not allowing any risk mitigation through investment account management – that is, management of the risks and returns of the underlying assets in order to produce the desired outcomes.<sup>22</sup> For example, many banks with sharply divergent risk profiles and returns on assets seem to be offering almost identical returns to unrestricted IAHs, and these are broadly in line with the general rate of return on deposits in conventional banks.

These relationships have been analyzed empirically in Sundararajan (2005). The evidence reveals a significant amount of return smoothing, and a significant absorption of risks by bank capital (and thus, only a limited sharing of risks with IAHs). This finding raises a broader issue of how best to measure empirically the extent of risk sharing between unrestricted investment accounts and bank capital.

A specific framework for such measurement is suggested below. The definition and measurement of *mudarabah* profits are first discussed; a methodology is then presented for calibrating risk sharing between IAHs and bank owners based on a VaR methodology.

## 4.1. Accounting Definitions

The relationship between *mudarabah* income and overall return on bank assets can be specified based on available accounting standards. Drawing on this relationship, a methodology to measure the risks facing IAHs, and the risk sharing between bank owners and IAHs, is suggested.

According to Financial Accounting Standard No. 6 (FAS 6) of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), when a bank commingles its own funds (K = Capital) and current account (CA) funds guaranteed by the bank (so that these count as part of the mudarib's funds for risk-bearing and profitsharing purposes) with mudarabah funds (DI = unrestricted IAH), profits are first allocated between the mudarib's funds K + CA and the funds of investment account holders, DI, and then the share of Islamic bank as a mudarib for its work is deducted from the share of profits of the IAHs.

In addition, FAS 6 states that profits of an investment jointly financed by the Islamic bank and unrestricted IAHs shall be allocated between them according to the contribution of each of the two parties in the jointly financed investment. Allocation of profit based on percentages agreed upon by the two parties is also juristically acceptable (according to the principle of *musharakah*), but the standards call for proportionate contribution.

The minimum standard for calculating the rate of return - specified by the Bank Negara Malaysia in the Framework of the Rate of Return (2001, and revised 2004) - calls for the sharing of profits between depositors - that is, unrestricted IAHs - and the bank as mudarib to be uniform across banks as specified in the framework documents, and provides a uniform definition of profit and provisions to ensure a level playing field. Profit is defined as income from balance sheet assets plus trading income minus provisions, minus appropriations to (or plus releases from) profit equalization reserves. minus the income attributable to capital, specific investments, and due from other institutions. This is the mudarabah income (RM) distributable between investment depositors (unrestricted IAHs) and the bank (as mudarib). Provisions are defined as general provisions plus specific provisions and income-in-suspense for facilities that are non-performing. The framework then distributes mudarabah income between the IAHs and the bank as mudarib and then by type and structure of IAH deposits.23

In addition, both AAOIFI standards and the rate of return framework of the Bank Negara Malaysia recognize the profit equalization reserve and investment risk reserve. PER (or R<sub>p</sub>) refers to amounts appropriated out of gross income in order to maintain a certain level of return for depositors (IAHs); and this is apportioned between IAHs and shareholders in the appropriate proportions that apply to the sharing of profits. IRR are reserves attributable entirely to IAHs, but are maintained specifically to cover losses on investments made with their funds.<sup>24</sup>

## 4.2. Measuring Risks in Investment Accounts and Risk Sharing

Given the framework for the computation of *mudarabah* profit – to be apportioned between the *mudarib* and the unrestricted IAH – and the policies on PER and IRR, the risk (defined as unexpected losses) of investment deposits can be calculated based on the variance of the rate of return for IAHs. Computation of such unexpected losses

under alternative scenarios for income smoothing (that is, alternative policies on PER and IRR) can provide the basis for estimating the adjustment factor  $\alpha$ , which is subject to supervisory discretion under the new IFSB capital adequacy formula. This approach is based on the consideration that effective investment account management would help to determine a value for  $\alpha$  that is consistent with the risk–return preferences of IAHs and the bank's response to these. A further elaboration of these issues, including precise approaches to estimation of  $\alpha$ , is the subject of a separate paper currently under preparation.

#### 5. SUMMARY AND POLICY CONCLUSIONS

The application of modern approaches to risk measurement, particularly for credit risk and overall banking risks, is important in Islamic finance for at least four reasons:

- to properly recognize the unique mix of risks in Islamic finance contracts
- to ensure proper pricing of Islamic finance facilities, including returns offered to IAHs
- · to manage and control various types of risks
- to ensure adequacy of capital and its effective allocation, according to the risk profile of the IIFS.

The preliminary review of the current state of financial reporting and disclosure among IIFS suggests that systematic future efforts at data compilation would be needed, particularly to measure credit and equity risks with some degree of accuracy. The situation is similar for many conventional banks, but the need to adopt new measurement approaches is particularly critical for Islamic banks because of the role IAHs play, the unique mix of risks in Islamic finance contracts, and the need to make more active use of security markets and securitization products for risk management. For these reasons, rapid progress is important in consumer-friendly disclosures to inform IAHs of the risk—return mix they face, and in market-oriented disclosures to inform markets of capital adequacy, risk exposures, and risk management.

In addition, managing the risk-sharing property of investment accounts through proper pricing, reserving, and disclosure policies would greatly enhance risk management in Islamic finance. This requires measurement and disclosure of aggregate value at risk of mudarabah income in the consolidated balance sheet of IIFS, and greater use of asset securitization in order to offer assets of specific risk-return characteristics to IAHs. Also, a measure of the extent to which the risks to shareholders are reduced on account of risk sharing with IAHs should be the basis of any capital relief or lower risk weights on the assets funded by investment accounts. For example, the proposed capital adequacy standard for Islamic banks (IFSB, 2005b) calls for supervisory discretion in determining the share "a" of risk-weighted assets funded by PSIA that can be deducted from the total risk-weighted assets for the purpose of assessing capital adequacy. This share, "a," represents the extent of total risk assumed by the PSIA, with the remainder absorbed by the shareholders on account of displaced commercial risk.

These observations suggest several policy and operational considerations and proposals:

- Appropriate measurement of credit and equity risks in various Islamic finance facilities can benefit from systematic data collection efforts, including by establishing credit (and equity) registries.
- IIFS would require both centralized and integrated risk management that helps to control different types of risks while allowing disaggregated risk measurements designed to price specific contracts and facilities, including the risk-return mix offered to IAHs. This integrated approach to risks would need to be supported by appropriate regulatory coordination and cooperation among banking, securities, and insurance supervisors.
- The disclosure regime for IIFS needs to become more comprehensive and transparent, with a focus on disclosures of risk profile, risk-return mix, and internal governance. This requires coordination of supervisory disclosure rules and accounting standards, and proper differentiation between consumerfiendly disclosures to assist investment account holders, and market-oriented disclosures to inform markets.
- The supervisory review process should monitor and recognize the actual extent of risk sharing by IAHs in assessing capital adequacy, and thereby encourage more effective and transparent risk sharing with IAHs. Adequate disclosure by an IIFS of the credit and market risks borne by PSIA and shareholders, respectively, should be a supervisory requirement for

giving a low value to the  $\alpha$  parameter in the capital adequacy formula to be applied to that IIFS. Thus, inadequate disclosure would result in a high value being set for this parameter (equivalent to granting little or no "capital relief" in respect of the share of these risks that might otherwise be considered to be borne by PSIA). The measurement of these risks, and estimation of appropriate capital relief, can be based on VaR methodology as suggested in Section 4.

#### **ENDNOTES**

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- Clearly there is no juristic obligation under the Shari'ah for the bank to absorb risk for the benefit of IAHs; in fact, the reverse is true. But in some jurisdictions the central bank takes the view that, as unrestricted PSIA are marketed as a substitute for conventional deposits, the bank has a constructive obligation to maintain its capital intact and to pay a competitive return.
- <sup>2</sup> Since the restricted investment accounts are not generally considered as a substitute for conventional deposits, this issue does not normally arise for them; although as a matter of commercial policy a bank in a particular year may decide to waive part of its mudarib share from such accounts in order to offer a better return to the IAH.
- 3 See "IMF facilitates establishment of IFSB," IMF news brief no. 02/41, May 2002; www.imf.org/external/mp/sec/nb/2002/nb241.htm.
- See papers presented at the seminar on The Ten-year Master Plan for the Islamic Financial Services Industry, held in Putrajava, Malaysia, May 2005.
- The amount need not be physically paid out, but may be credited to the IAH account, from where it can be either withdrawn or left as an addition to the balance invested.
- 6 The movements on IRR are also relevant, but are not explicitly included in this analysis for the sake of simplicity.
- For a discussion of appropriate practices in defining mudarabab profits, see AAOIFI, Financial Accounting Standard No. 6, and the Framework of the Rate of Return (October 2001, and revised 2004) issued by the Bank Negara Malaysia. For examples of estimation of such earnings and PaR measures for Islamic banks, see Hakim (2003) and Hassan (2003).
- 8 In the case of an ijarah-based facility, the risk is that of default by the lessee that is, failure to keep up lease payments. However, in an ijarah, the bank as lessor retains ownership of the leased asset and can normally repossess it in the event of default by the lessee.
- <sup>9</sup> Musharakah- and mudarahah-based facilities give rise to risks of non-performance that are analogous to credit risk but are typically higher, as the customer has no legal obligation to repay capital or pay a return unless a profit is earned on the underlying investment. See Section 3.3 below.
- 10 Basel II definition (paragraph 452).

- 11 For a survey of new approaches to credit risk measurement and an overview of traditional methods, see Saunders and Allen (2002).
- 12 AAOIFI (2001), Financial Accounting Standard No. 2, Appendix B.
- 13 Djojosugito (2003).
- 4 Chapra and Khan (2000).
- 15 See Wilson (1998) and Caouette et al. (1999) for detailed illustration.
  - 16 IFSB (2006b).
- Basel II also proposes another method whereby the loss can be estimated by using the PD corresponding to a debt exposure to the counterparties whose equity is being held, and applying a fairly high loss-given default such as 90% to reflect the equity risks. A measure of both expected and unexpected loss could then be computed from these parameters. However, the notion of "debt exposure" as such is problematic in Islamic finance, and this method is not proposed in the IFSB Standard, which suggests that the method proposed in Basel II based on "supervisory slotting criteria" for specialized lending may be adapted for such risks.
- 18 The concept of a risk-free rate is problematic in Islamic finance, since a risk-free return is not Shari'ah-compliant. However, the suggestion here is to use such a rate merely as a component in a calculation, not in an actual transaction.
- <sup>19</sup> In principle, in the presence of profit-sharing and loss-bearing investment account holders, the changes in asset returns due to changes in the benchmark market rate of return would be offset by corresponding shifts in the returns payable to IAHs. In practice, as a result of return smoothing, the risk of losses due to changes in market rates of return would remain significant.
- 20 Alternatively, the impact on the present value of earnings of shifts in the rate of return can be calculated directly from duration measures as follows: impact of change in rate of return = (D<sub>A</sub> D<sub>L</sub>)Δi<sub>r</sub>, where: D<sub>A</sub> = duration of funding; and Δi<sub>r</sub> = change in rate of return.
- 21 Basel II, paragraph 644.
- <sup>22</sup> In at least some cases this may, however, be a way of managing the different risk appetites of shareholders and investment account holders. The bank adopts a more aggressive investment strategy than would be appropriate for IAHs, and then uses "smoothing" methods to produce the outcomes for IAHs of a more defensive strategy. The investment accounts are thus used as a form of leverage. See Al-Deehani et al. (1999) and Archer and Karim (2005).
- Thus, the income to the bank has two components: the return on bank capital used in calculating the mudarabab profits (this is the return to the bank's contribution as a co-investor) plus the mudarib share of the mudarabah's profits. (This is the fee for its asset management services.)
- 24 It would not be Shari'ab-compliant for the PER to be used for this, as this would amount to the mudarib absorbing part of the loss.

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# Capital Structure and Risk in Islamic Financial Services

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## INTRODUCTION: INFORMATION, RISKS, AND CAPITAL

Pinancial intermediation is a critical factor for growth and social inclusion. One of its core functions is to mobilize financial resources from surplus agents and channel them to those with deficits. It thus allows investor entrepreneurs to expand economic activity and employment opportunities. It also enables household consumers, micro-, and small entrepreneurs to expand their own welfare and earnings opportunities, and seek to smooth their lifetime outlays. In all cases, financial intermediation drives economic growth and contributes to social inclusion, provided it is conducted in a sound and efficient way.<sup>1</sup>

A financial intermediary's ability to process information on risks and returns of investment opportunities will have a bearing on the soundness and efficiency of its resource mobilization and reallocation function. Conventional financial services (CFSs) process information through institutions or markets, and have generally evolved from the former to the latter. In both cases, markets and agents provide alternative ways of processing information on risks and returns of investment opportunities. In the first form, the intermediary raises capital to set up business to collect generally liquid deposits from surplus agents and reallocates these resources, now in his trust, to

ones with deficits in generally less liquid assets. In the second form, surplus agents buy directly financial assets that represent a debt of a deficit agent or an ownership share in its business. In either approach, both categories of agents engage in transactions on the basis of trust and of expectations about the degree of liquidity that would provide the option to re-contract at a reasonable cost.<sup>2</sup> In the case of banks, the trust can be seen as based on proprietary information. In the case of markets, the information is more commoditized and widely available.<sup>3</sup>

Efficiently processed information can support the efficient allocation of capital. It can help a financial intermediary to better define the capital it would need to achieve the returns sought, while maintaining its ability to face the financial consequences of unexpected events that may endanger its stability. Banks engage in gathering and processing information on clients and markets, which allows them to manage different risks by unbundling them and reallocating the components. By performing these services soundly and efficiently, banks can manage to calibrate their capital requirements and receive diversified income streams. Thus a bank's investors and customers can gain comfort as to its reliability in allowing them to access liquidity and maintain stability. In parallel with banks, financial markets can also convey the same sense of access to liquidity and stability based on disclosed and broadly available information on market participants. Markets can provide deficit and surplus agents a direct role in processing information to facilitate the unbundling and reallocation of risks and the efficient use of capital. Thus, banks and markets compete and complement each other in financial intermediation. The competition puts pressure on individual agents to use capital at their disposal efficiently, and results in a system-wide improved allocation of capital resources.4

Institutions offering Islamic financial services (IIFS) also process information on risks and returns of investment opportunities while complying with Shari'ah principles. Thus, in principle, they can be expected to increase competition in financial information processing by inducing better risk management and capital use. Such competition can be expected over time to lead to an efficient use of capital at the level of each financial agent, whether they practice conventional or Islamic finance, and in aggregate, system-wide across all modes of financial intermediation. Efficient use of capital is thus a challenge which competition imposes on all financial intermediaries, whether offering Islamic financial services or conventional financial services. At

the same time, Islamic financial intermediation needs to comply with Shari'ah principles, notably those of risk sharing and materiality of financial transactions. Shari'ah compliance, social responsibility, and the discipline of competition compound IIFS's challenge to process information efficiently in order to manage the risks they may face and use their capital endowments. Thus, by their very nature and the environment in which they generally operate, IIFS need to be well equipped with the information and skills that can allow them to identify their capital resources and use them efficiently.

This chapter argues for the need for Islamic financial services to strengthen risk management practices in the process of defining their own capital requirements in accordance with their loss tolerance. It suggests that IIFS could invest in the collection of loss information and adoption of loss data management systems. IIFS would benefit from implementing risk management methodologies and adapting their staffing skills accordingly. The chapter starts in Section 2 by outlining views on the relationship between risk management and capital for financial intermediation. It then overviews risk categories as an initial step in risk management in Section 3. Section 4 discusses regulatory and economic capital, introducing risk occurrence frequency as a distribution probability. Section 5 concludes with suggestions on steps that may help with risk management and improve the competitiveness of IIFS.

### 2. BANK CAPITAL AND RISK MANAGEMENT

Bank capital may be considered as consisting of (a) equity capital and (b) certain non-deposit liabilities or debt capital (see Section 4). It is both a means of funding earnings-generating assets and a stability cushion. From the perspective of efficiency and returns, capital is part of a bank's funding that can be applied directly to the purchase of earning assets, as well as being used as a basis for leverage to raise other funds for expanding assets with the net benefit accruing to shareholders. From a perspective of stability, bank capital is a cushion for absorbing shocks of business losses and maintaining solvency, with benefits accruing to depositors and other stakeholders. Both financial intermediaries and regulators are sensitive to the dual role of capital, as a means of funding earnings-generating assets and as a cushion for dealing with unanticipated events. Financial intermediaries may tend to be more focused on the former role and regulators on the latter.

A bank's capital structure decision relates to the ratio of capital to deposits and to the ratio of debt capital to equity capital. Its performance, in terms of return on equity capital, will be influenced by its ability to calibrate the level of capital it requires. Through efficient risk management, it can reach a sense of which capital structure can best help it to: (a) achieve profitability while maintaining stability; (b) reassure markets as to the quality of its business conduct; and (c) have a constructive dialogue with regulators.

Efficient use of capital will help IIFS to achieve profitability and stability. Allocating capital resources to low-performing or excessively risky assets is bound to drag down performance, endanger stability, or both. Equally, leaving capital idle entails at best foregoing earnings opportunities. For instance, overly cautious approaches that lead financial intermediaries to maintain larger amounts of capital than warranted by their risk profile may not allow them either to obtain the full potential of their capital or to contribute effectively to the development of the communities they serve. At the other end of the spectrum, a financial intermediary overly eager to achieve returns may allocate resources to highly risky assets that offer high returns but endanger stability. Explicit risk management practices can help in the selection of assets to which capital and other resources are applied and calibrate the level of capital that best suits business objectives and stability tolerance.

The size and composition of the resources that capital enables financial intermediaries to raise are likely to affect their profitability and stability. In a frictionless world where full information is available and markets are complete, the value of a firm would be independent of its capital structure, and so the focus should be on capital level and not structure.6 Under such circumstances, the method by which a financial intermediary raises its required funds would be irrelevant. However, financial intermediaries do not operate in a frictionless world; they face imperfections such as costs of bankruptcy and financial distress, transaction costs, asymmetric information, or taxes. They also operate within the framework of a governing regulation possibly with a deposit insurance scheme that is expected to provide a safety net. In fact, one may contend that these market imperfections are the very reason for the successful existence of banks as financial intermediaries. Accordingly, not only a financial intermediary's level of capital but also its structure are likely to bear on its market valuation, its business conduct, and its stability. Effective risk management strategies

should contribute to a financial intermediary's ability to assess not only the level of capital it would need in relation to assets and deposits, but also the extent to which its structure affects its value.

Market discipline contributes to responsible corporate behavior. Markets' reactions to perceptions of a financial intermediary's business conduct and capital strength may be unforgiving. It is thus in the interest of financial intermediaries to develop approaches to defining capital resource requirements that take into account the institutional environment in which they operate. The market's perception of market imperfections is likely to influence views on the appropriate level of capital and the capital adequacy of financial intermediaries. For example, the availability of a safety net may lead market participants to be less demanding as to the need for capital in relation to bank assets. Conversely, anticipation of high costs of financial distress to depositors and other stakeholders may induce market participants to require the holding of more capital proportionally to assets. Similarly, wherever the institutional environment is weak and contract enforcement is uncertain and costly, markets may expect financial intermediaries to adapt the capital they hold.

The management of capital structure should in principle mitigate the risk of bank failures. When comparing a highly leveraged bank and a bank that is well-capitalized, the leveraged bank will likely experience a greater loss of value during times of financial distress when the asset quality deteriorates, due to the increased risk of bankruptcy. To cope with downturns, in most countries banks hold a minimum amount of capital, based on the risk embedded in their asset holding. Accordingly, banks with relatively risky assets would hold a higher amount of capital than those banks with less risky assets. However, fearing the harshness of market discipline, many banks maintain a higher level of capital than the minimum required to allay the perception that they may be undercapitalized and avoid the losses this may induce, as witnessed in the 1980s. The key capital adequacy ratio provides an assessment of just how adequately the capital cushions such fluctuations in the bank's earnings and supports higher assets growth.

Finally, efficient risk management should allow financial intermediaries to have a constructive dialogue with regulators. It would help them to articulate their views with respect to capital needs. The regulators' rationale for regulating capital stems from the perception of the public-good nature of bank services, their potential macroeconomic growth and stability impact, and experience with costly bank failures. According to some estimates, such costs have varied between 3% and 55% of GDP.7 Thus, regulators' concerns with possible systemic risk resulting from the contagion effects of bank runs lead them to seek to mitigate risks of financial distress with regulatory requirements on banks' capital.8 Regulators' concerns may be compounded by the presence of deposit insurance schemes. The moral hazard that may result from deposit insurance may lead to additional regulatory requirements such as linking the level of insurance premia to the risk embedded in assets and captured in associated risk weights. Indeed, deposit insurance may induce banks to lever up capital by expanding their own funding with liabilities, thus placing more risk on their capital and increasing their vulnerability. Efficient risk management practices would allow banks to improve their dialogue with the regulator and convey more convincingly their views on their soundness and capital requirements.

Regulators would generally also be concerned with the overall impact on the economy of the resources raised by the financial system under their purview. From an economy-wide perspective, banks may be viewed as firms' competitors in raising capital on financial markets. The outcome of this competition has a bearing on economic performance and financial stability, and points to a cost-benefit tradeoff in holding capital. For instance, Gersbach (2002) suggests that a benefit of bank capital is the equity acting as a buffer against future losses, thereby reducing excessive risk taking of the banks. At the same time, raising bank capital may lead to a crowding out of industrial firms, limiting their access to equity and other market funding and also impacting their access to funding from banks and its cost, Furthermore, raising equity on markets may increase the cost of banks' resources, inducing them to seek to invest in higher-vielding but more risky assets and thereby increasing their risk exposure. Thus, while potentially providing a cushion against unforeseen events, a higher level of equity may actually induce more risk taking, notably through raising the cost of funds to banks and their clients. Efficient risk management can provide inputs to both banks and regulators to better calibrate capital needs and deal with the foregoing type of tradeoff.

The level of a financial intermediary's capital may also have a bearing on its ability to provide liquidity. The financial intermediary provides liquidity by funding assets that may be less liquid than the deposit resources it collects. There is a view that requirements for higher levels of capital may have a negative impact on liquidity creation.9 On the liability side, a higher capital requirement may lead to a corresponding reduction in the level of deposits, thus constraining the ability to provide liquidity. Also, higher capital requirements may induce financial intermediaries to be more restrained in extending financing, thus constraining their ability to provide liquidity, However, according to another view, higher capital would allow the financial intermediary to create more liquidity since its risk-absorptive capacity would be improved. 10 In this regard, an empirical study concluded that for larger banks capital has a statistically significant positive net effect on liquidity creation, while for small banks this effect is negative.11 Accordingly, each financial intermediary would need to evaluate carefully the level and composition of the capital it needs, since the latter plays a significant role in its ability to function as a liquidity provider. Equally, regulators would need to pay attention to the impact which capital requirement would have on the funding of the economy.

IIFS's risk management arrangements will bear on their ability to calibrate capital to their business objectives and risk tolerance, to deal with market discipline, and to maintain a dialogue with regulators, The IIFS's characteristic of mobilizing funds in the form of risk-sharing investment accounts in place of conventional deposits, together with the materiality12 of financing transactions, may alter the overall risk of the balance sheet and, consequently, the assessment of their capital requirements. Indeed, risk-sharing "deposits" would in principle reduce the need for a safety cushion to weather adverse investment outcomes. Similarly, the materiality of investments is likely to modify the extent of their risk and have a bearing on the assessment for the overall need for capital; asset-based modes of finance may be less risky, and profit-sharing modes more risky, than conventional interestbearing modes. Nevertheless, IIFS would operate within a regulatory framework that is likely to impose on them capital requirements with a view to promoting stability and limiting contagion risks. However, besides regulatory and market demands for IIFS to hold capital, IIFS need to put in place risk management assessments for their own purposes of returns and stability in accordance with the requirements of Shari'ah, their own mission statements, and the protection of their stakeholders.

#### 3. RISK IDENTIFICATION AND RISK MANAGEMENT

Efficient risk management capability is necessary to enable IIFS to strategically position themselves in the global market by using their capital efficiently. <sup>13</sup> Weak risk management systems may deprive IIFS of the ability to hedge risks, and undermine their potential contribution to the communities they aim to serve. Adequate resources need to be devoted to risk identification and measurement, as well as to the development of risk management techniques. In this respect, there is a pressing need to combine solid understanding of *Shari'ah* law with a good knowledge of modern risk management techniques so as to be able to develop innovative risk mitigation and hedging instruments.

An initial step is a clear identification of risks that may arise in the conduct of Islamic financial intermediation. In carrying out their function, banks manage portfolios of assets and liabilities as well as their capital. Accordingly, each asset, each portfolio, and the intermediary as a whole are subject to risks. Exhibit 4.1 outlines the main risks intermediaries face under four broad categories. Each risk category captures the occurrence of some event that would affect the performance of an asset, a portfolio, or the whole balance sheet.

In extending financing and raising resources, IIFS face risks similar to those encountered by their conventional counterparts, but with variations due to specific requirements to comply with Shari'ah. The requirement of materiality of the financing transaction and the prohibition of interest shape the nature of the instruments IIFS can use and their embedded risk. The foregoing features also put constraints on the ability of IIFS to manage liquidity, as they may not have recourse to repo facilities and interest-bearing instruments characteristic of money markets. In addition, the prohibition of gharar (the assuming of uncertainty or risk) constrains the use of hedging instruments useful for asset-liability management. Furthermore, there may be operational risks in failing to ensure Shari'ah compliance. Exhibit 4.2 outlines the specific risks facing IIFS.<sup>14</sup>

Credit risk for IIFS arises in connection with accounts receivable in murabahah contracts, counterparty risk in salam contracts, accounts receivable and counterparty risk in istisna'a contracts, and lease payments receivable in ijarah contracts. To On average across IIFS balance sheets, murabahah appears to be the dominant mode of financing (41%), followed by musharakah (11%), mudarabah (12%), and

EXHIBIT 4.1 Outline of the risks facing financial intermediaries

Type of risk	Rationale	
Financial risk		
Credit risk	The risk of counterparty failure to meet their obligations in a timely manner.	
Interest rate risk	(a) Risk of a reduction in the value of a fixed-interest asse (e.g. bond) due to a rise in interest rates (part of marke risk, unless the asset is in the "banking book" – see (b)	
	(b) Risk of an interest rate mismatch between fixed-rate assets and floating-rate liabilities, or vice-versa, resulting in a profit and cash flow "squeeze."	
Market risk	Risk common to entire class of assets or liabilities due to economic changes or external events (systemic risk, e.g. changes in stock market sentiment, interest rates, currency or commodity markets).	
Liquidity risk	Risk that arises from the difficulty of trading an asset (ass liquidity risk) and difficulty in obtaining funding at a reasonable cost (financing liquidity risk),	
Settlement risk	Risk that a counterparty does not deliver security or its value in cash as per agreement when the security is traded after other counterparty(ies) have delivered security or cash as per agreement.	
Prepayment risk	The risk of loans (especially mortgage loans) being prepa- before maturity due to a drop in interest rates,	
Operational risk	Risks associated with the potential for systems failure in a given market; usually resulting from inadequate interna processes and strategies, people, and systems, or from external events.	
Business risk		
Legal and regulatory risk	Due to changes in the law and regulations that adversely affect a bank's position.	
Volatility risk	Fluctuations in the exchange rate of currencies.	
Equity risk	Depreciation of investments due to stock market dynamic etc.	
Country risk	Potential volatility of foreign assers due to political or financial events in a particular country.	
Event risk	Unpredictable risks due to unforeseen events such as banking crises, contagion effects, and such other exogenous factors.	

ijarah (10%). Thus the bulk of the financing may still essentially be trade financing, with more limited engagement in profit-sharing assets and leasing. Accordingly, it may still be the case that credit risk is the dominant risk IIFS need to contend with.

EXHIBIT 4.2 Risks specific to Islamic financial services

Type of risk	Rationale	
Commodities and inventory risk	Arising from holding items in inventory either for resale under a murababah contact, or with a view to leasing under an ijarah contract.	
Rate of return risk	Similar to interest rate risk in the banking book. However, IIFS are not exposed to interest rate risk as such, but to a "squeeze" resulting from holding fixed-return assets such as murababab that are financed by investment accounts, the holders of which (investment account holders) expect a rate of return risk in line with benchmark rates. An increase in benchmark rates may result in investment account holders having expectations of a higher rate of return (see also mark-up risk).	
Legal and Shari'ah compliance risk	Risks associated with the potential for systems failure in a given market; usually resulting from inadequate internal processes and strategies, people, and systems, or from external events. This includes legal and Shari ab compliance risk.	
Equity position risk in the banking book	Arises from the equity exposures in mudarabah and musharakah financing contracts.	
Mark-up risk (benchmark risk)	Since IIFS do not use interest, they use market rates as benchmarks in pricing their products. Hence, there is a risk associated with the changes to the benchmark rate (see rate of return risk).	

A major cause of serious financial intermediaries' potential distress continues to be lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other external circumstances that can adversely impact the credit standing of a bank's counterparties. <sup>17</sup> It is notably the predominance of this credit risk that underlines the Basel II Accord's recommendations of the three approaches to credit risk assessment for capital adequacy purposes: the Standardized Approach, the Foundation Internal Rating-Based (IRB) Approach, and the Advanced IRB Approach. In various degrees, these approaches provide banks with the opportunity to have their own credit risk assessment methodology contribute to the identification of capital needs. The better equipped a financial intermediary is in risk management, the more opportunity it would have to calibrate its capital needs and use its resources most efficiently, thus strengthening its competitive position.

Accordingly, the quality of IIFS's risk management plays a critical role in determining their competitiveness.

In contrast to the foregoing, there may be a perception within IIFS that the most critical risk they face may be the mark-up risk or rate of return risk. <sup>18</sup> In order of importance, it would be followed by operational risk and liquidity risk. While credit risk is the predominant risk most financial intermediaries (whether CFS or IFS) deal with, surveyed IIFS do not perceive it as being as severe as most other risks they identify. IIFS appear to consider market risk as the least serious (see Exhibit 4.3).

A clear identification of the event and its translation into a measurable variable would be a prerequisite to render the notion of risk operationally relevant, in the sense of guiding actual business conduct. For example, an ijarah contract on a movable asset may not be serviced according to the signed agreement. Assuming, for simplicity, that the contract may be only either serviced or not (that is, there is either no default in payment by the lessee, or there is default), then the risk variable becomes the occurrence of the event of default. It is an observable variable that may take a value of one if there is default and zero otherwise. Over time, observations on the risk profile of various instruments extended to various categories of IIFS clients can be developed. These statistical observations can be used to strengthen risk management and guide the extension of financing. Thus for each identified risk, there is a necessary step to translate it into an observable variable and set up a system to collect and maintain the relevant information, as well as to develop methodologies to process the information to guide decision making, Admittedly, not all possible risks may be anticipated and translated into an observable variable capturing the occurrence of an event.

EXHIBIT 4.3 Risk perception: Overall risks faced by Islamic financial institutions

	Number of relevant responses	Average rank
Mark-up or rate of return risk	15	3.07
Operational risk	13	2.92
Liquidity risk	16	2.81
Credit risk	14	2.71
Market risk	10	2.50

<sup>\*</sup> The rank has a scale of 1 to 5, with 1 indicating "Not Serious" and 5 denoting "Critically serious."

Source: Adapted from Khan and Ahmed (2001).

Furthermore, events may not be mutually independent, pointing also to the need to focus on their possible correlation, its observation and measurement. Experience with risk identification and management practices can only be helpful.

#### 4. REGULATORY AND ECONOMIC CAPITAL

Progress in risk management and evolving regulators' and market participants' views are prompting changes in the determination of capital requirements. Regulators may have been initially concerned mainly with depositors' protection, stability and contagion issues, while financial intermediaries' focus would have been essentially on business profitability and expansion. Accordingly, in initial approaches, regulators set a general rule, applying to all without much differentiation, requiring financial intermediaries to hold a minimum amount of capital. Regulators' caution had led to what could be qualified as a relatively blunt capital adequacy rule. Flaws in the rule and a convergence of concerns between regulators and financial intermediaries led to other approaches better adapted to specific conditions of markets and intermediaries. Over time, regulators' awareness of their role in market development expanded at the same time as financial intermediaries' sense of corporate responsibility in promoting market stability. Progress in risk management approaches facilitated the evolution. Accordingly, regulation is evolving from rule-based, relatively blunt capital requirements to risk-based assessments of capital needs, or economic capital.

## 4.1. Regulatory Capital

From one perspective, capital is viewed as the funding source to be used to protect the parties who have claims on banking assets, such as depositors, against unexpected losses. In order to ensure that banks are sufficiently funded for that purpose, or adequately capitalized, regulators have come up with regulatory minimum capital requirements under Basel Capital Accords. The focus of the initial 1988 accord was on a cushion for credit risk. This was amended in 1996 to include capital requirements to cover market risks. However, during the late 1990s, with the growth of securitization and credit derivatives, some financial intermediaries resorted to regulatory arbitrage using regulatory inconsistencies to increase profitability (the return on capital) at the expense of capital adequacy. Another development was the resort

to the rolling over of short-term loans whose risk weight was nil or negligible, thus increasing financial corporate fragility. Concerns about the evolving nature of risks and these developments prompted a review of the Basel I framework and motivated the development of the Basel II Accord. A major thrust was an emphasis on taking better account of the risk profile of the intermediary and its ability to manage risks in reaching a sense of its capital requirement. In addition, in the course of developing the Basel II framework, attention was given to operational risk and a related requirement for a capital cushion.

The capital adequacy pillar of the Basel II framework (Pillar 1) proposes three alternative approaches (as mentioned above) to assessing the capital requirement to associate with credit risk. 19 Risk weights to be used in respect of credit risk are obtained based on one of three models that rely more or less on the financial intermediary's own internal risk rating. In the simple model, or standardized approach, the risk weighting system relies on external agency ratings of the borrowers. In a more elaborate model, the financial intermediary uses its own risk management model to obtain internal ratings. Whether externally or internally derived, the risk weights are used to obtain a value of the assets that incorporates credit, market, and operational risk. The banking institution would be expected to maintain a minimum capital to risk-weighted assets ratio of 8% at all times. Hence, regulatory capital requirement is linked directly to an assessment of the degree of risk of the assets a bank holds. Thus, to improve its capital adequacy ratio, a bank would have the option either to increase its capital or to reduce the risky assets it holds, or a combination of both. A contribution of the new Basel Accord is to insert alternative ways of assessing the risks associated with the assets held, with a larger role given to a bank's own risk assessment if the regulator is satisfied with its ability to make such assessments. Salient features of the Basel II Accord are highlighted in Eyhibit 4.4.

Capital requirement standards have been developed for IIFS adapting conventional Basel approaches. A first guidance was given by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) recommending not including the risk-sharing account deposits in capital. Recently, the Islamic Financial Services Board (IFSB) issued a capital adequacy standard based on the Basel II Standardized Approach with a similar approach to risk weights. However,

#### EXHIBIT 4.4 Salient features of the Basel II Accord

#### Pillar 1: Minimum capital requirements

- · Risk-sensitive Standardized Approach proposed.
  - Risk weights derived from the credit assessments of eligible export credit agencies (ECAs) to be used.
  - · Operational requirements to ensure supervisors' objectivity in risk assessment.
  - Credit risk mitigation to be done using collateral, derivatives, guarantees, etc. subject to disclosure requirements under Pillar 3.
- More risk-sensitive Internal Ratings-Based (IRB) Approach proposed.
  - Banks with more advanced risk management capabilities to use internal assessments.
  - For the foundation approach, banks should use an internal assessment system which could differentiate risks, estimate probability of default, use internal ratings, etc.
  - For the advanced IRB approach, in addition to requirements under the foundation approach, additional requirements to be met for relevant risk components being estimated by them.
- Operational risks to be covered by an explicit capital charge. (Minimum capital charge to be approximated at 12%.)
- Trading book issues: guidelines issued with respect to overall management risk assessment, valuation, etc.

#### Pillar 2: Supervisory review process

Four key principles of supervisory review are issued to complement the supervisory vaidelines already established.

- First key principle: Banks to have a process for assessing their overall capital adequacy in relation to their risk profiles and a strategy for maintaining their capital levels.
- Second key principle: Supervisors should review and evaluate banks' internal
  capital adequacy assessments and strategies, as well as their ability to monitor
  and ensure their compliance with regulatory capital ratios. Supervisors should
  take appropriate supervisory action if they are not satisfied with the result of this
  process.
- Third key principle: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
- Fourth key principle: Supervisors should seek to intervene at an early stage to
  prevent capital from falling below the minimum levels required to support the risk
  characteristics of a particular bank and should require rapid remedial action if
  capital is not maintained or restored.

#### Pillar 3: Market discipline

Specific qualitative and quantitative disclosure requirements in respect of four key areas are issued.

- General disclosure principle
- · Scope of application
- · Capital
- Risk exposure and assessment.

the minimum capital adequacy requirements for both credit and market risks are set out for each of the Shari'ah-compliant financing and investment instruments. The IFSB standard (IFSB, 2005) calls for supervisory discretion in determining a share " $\alpha$ " of risk-weighted assets funded by risk-sharing investment deposits that can be deducted from the total risk-weighted assets for the purpose of assessing capital adequacy. This share " $\alpha$ " represents the extent of total risk assumed by the investment account holders, with the remainder absorbed by the shareholders on account of displaced commercial risk. The for CFSs, the minimum capital adequacy requirement for IIFS in the IFSB standard is also not lower than 8% for total capital.

## 4.2. Definitions of Capital

Defining what constitutes capital has been a long-debated issue. However, there is wide acceptance of the capital structure that has been stipulated by the Basel committee, where capital is segregated into three categories, as set out in Exhibit 4.5.

To be considered as adequately capitalized, requirements were set for the international banks in the G10 countries to hold a minimum total capital (Tier 1 and Tier 2) equal to 8% of risk-adjusted assets.

For IIFS, Tier 1 capital would be the same as in CFSs. The reserves, however, would include the shareholders' portion of the

EXHIBIT 4.5 Classification of capital in Basel accords

Classification	Contents
Tier 1 (core capital)	Ordinary paid-up share capital/common stock, disclosed reserves from post-tax retained earnings, non-cumulative perpetual preferred stock (goodwill to be deducted).
Tier 2 (supplementary capital)	Undisclosed reserves, asset revaluation reserves, general provisions/general loan-loss provisions, hybrid (debt/equity) capital instruments, and subordinated term debts. <sup>1</sup>
Tier 3	Unsecured debt: subordinated and fully paid up, to have an original maturity of at least two years and not be repayable before the agreed repayment date unless the supervisory authority agrees. <sup>2</sup>

Eligible Tier 2 capital may not exceed total Tier 1 capital, and long-term subordinated debt may not exceed 50% of Tier 1 capital.

This will be limited to 250% of a bank's Tier 1 capital, which is required to support market risks.

profit equalization reserve (PER), which is included in the disclosed reserves. <sup>22</sup> In Tier 2 capital, there would not be any hybrid capital instruments or subordinated debts as in CFSs, as these would bear interest and contravene *Shari'ah* principles. However, an issue is the treatment of unrestricted risk-sharing investment accounts that may be viewed as equity investments on a limited-term basis, in principle. In the debate on whether or not to include these accounts in Tier 2 capital, the AAOIFI committee on capital adequacy concluded that it would not be appropriate to include the PSIA in Tier 2 capital.

The Islamic Financial Services Board has taken a similar position. The IFSB Capital Adequacy Standard (IFSB, 2005) calls for supervisory discretion in determining a share " $\alpha$ " of risk-weighted assets funded by profit-sharing investment "deposits" that can be deducted from the total risk-weighted assets for the purpose of assessing capital adequacy. This share " $\alpha$ " represents the extent of total risk assumed by the investment account holders, with the remainder absorbed by the shareholders on account of displaced commercial risk. <sup>23</sup> As for CFSs, the minimum capital adequacy requirement for IIFS in the IFSB standard is not lower than 8% of total capital.

The issue is of major importance, as IIFSs use profit-sharing investment "deposits" as a form of leverage (Archer and Karim, 2006; Al-Deehani et al., 1999). Such deposits not only expose IIFSs to operational risk; there is also the issue of "displaced commercial risk" mentioned above.

## 4.3. Economic Capital

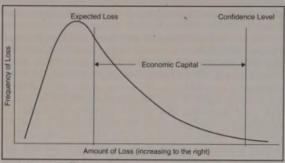
"Economic capital" represents the emerging practice for measuring and reporting all kinds of risk across a financial organization. Regulators have gradually factored in market development concerns in setting capital adequacy requirements by incorporating improved assessments of the risks embedded in the assets held by financial institutions. The latter have developed improved tools to assess the risks of their assets and their modes of operations. These tools allow financial intermediaries to reach better assessments of the economic capital they may need to best match their profit objectives and risk tolerance.<sup>24</sup> "Economic capital" would measure risk in terms of economic conditions, rather than potentially misleading regulatory or accounting rules. It is called economic capital as its identification involves converting a probability distribution

of occurrences of risk events into an amount of possible losses for which capital charges may be required, in line with the institution's target financial strength (for example, credit rating). As such, it should permit achieving higher economic efficiency in capital use.

Risks, such as those highlighted in the previous section, may lead in practice to expected as well as unexpected losses. Both would be based on the frequency of occurrence of an event and the loss that may be associated with it. For the purpose of calculating economic capital, the amount of expected losses is the average of the anticipated losses over a distinct period of time. This expectation should be formed using actual observations that normally happen in the conduct of normal business over a given period. The financial intermediary would factor these expected losses in its pricing and make corresponding adequate provisions. However, there are also losses that may not be part of the normal conduct of business and whose occurrence would be unexpected. They would be the outcome of a worst-case adverse event for which no specific provision can be made as part of normal business conduct. Here the actual losses would be expected to be large and exceed what normal pricing could cover. These unexpected losses may be so large that the financial intermediary may go on to default, but the frequency of occurrence of such catastrophic events would be expected to be very low under normal circumstances.

Exhibit 4.6 provides an illustration of a shape of a distribution of losses, highlighting the notion of expected and unexpected loss. The former is the mean or the average loss over a given period and may be covered by specific provisioning. Losses larger than expected losses would be expected to occur with increasingly lower frequency, the larger they are. Over a given period, covering such losses in all circumstances – that is, irrespective of the expected frequency of their occurrence – would require a large volume of capital. It would be prohibitive from a business perspective, as costly capital would be locked in low-return-yielding investments, and accordingly be uneconomical. Thus, financial intermediaries and regulators interested in market vibrancy would be interested in identifying the level of economic capital that would provide a sufficient stability cushion without stifling the financial intermediary, given the expected frequency of unexpected losses over a certain period. Hence, in its management of

EXHIBIT 4.6 A probability distribution of losses



Source: Burns (2004).26

unexpected risks, the financial intermediary may decide to conduct its business accepting that there may be, say, a chance of one in 100 of becoming insolvent in a given time period (say, in the next 12 months). It would just define its economic capital accordingly as that level of capital that would allow it to face unexpected losses whose probability of occurrence in the given time period may be not more than 99%.

In the above example, the 1% represents the probability that losses may exceed the economic capital. This type of loss may be due to a system shock that is rare, and hence not need to be covered by capital.<sup>27</sup> In computing the economic capital, credit and operating risks could be estimated using the probability distribution of historical losses, while for market risk it is possible to calculate the daily value-at-risk and then convert it to an amount of economic capital. Thus, economic capital can reflect a comprehensive risk measurement addressing the full range of risks faced by the financial intermediary. It is a useful tool in the hands of the management of the financial intermediary, allowing it to calibrate the level of capital that is economical to hold in order to achieve return and stability objectives. Provided the implemented methodology is sound and robust as well as transparent, it can provide a valuable foundation for a constructive dialogue with regulators and

other stakeholders that contributes further to market vibrancy and stability.

For simplicity, assume that Exhibit 4.6 provides the probability distribution of losses associated with murabahah contracts that finance trade within a 12-month period. The vertical axis on the left indicates the frequency of various levels of loss, and the horizontal axis at the bottom indicates the various amounts of losses that may occur. Thus, moving from the left to the right of the curve, the frequency of losses on those contracts initially increases with the size of losses; then, beyond a certain size of loss, it diminishes. Thus the expectation of losses over the period would be the sum of losses weighted by the expected frequency of their occurrence. However, larger losses may also occur but with lower and lower frequency as larger and larger sizes of losses are contemplated. Beyond a certain size of loss the intermediary would decide not to bother to cope with them and accept the possibility of not being able to protect its solvency. Beneath that size it would keep some economic capital reserve that would correspond to a measure of the sum of the difference between possible unexpected losses and expected losses, weighted by the frequency of occurrences of such differences. The foregoing approach could be extended to various types of contracts and elaborated to address correlations between risks, providing a comprehensive risk management tool.

While the modes of intermediation, financial instruments, and risks of IIFS and CFSs may differ, the general approach would be applicable to both types of financial intermediaries. A better-circumscribed economic capital can allow IIFSs to manage their resources more efficiently while providing comfort to their stakeholders. A major difference between IIFS and CFSs relates to investment account deposits. While for IIFS, the expected losses would be borne by the income, as in CFSs, the risk capital needed to meet unexpected losses may be less for IIFS since, theoretically, they accept investment deposits which are risk-sharing contracts. In principle, the Islamic financial intermediary would share in the profit as an agent-mudarib with the depositor, but the latter would bear losses that are the outcome of market conditions but not of a mudarib's misconduct. Hence the risk-sharing feature of investment account deposits would reduce the overall risks for IIFSs in principle. Under the circumstances, and going back to the murabahah contract illustration in the foregoing, the IIFS would be expected to conduct business in such a way as

to deal with expected losses, pricing its products and accumulating provisions accordingly. The IIFS would identify economic capital to deal with unexpected losses that are due notably to misconduct. Unanticipated adverse events that are beyond the reasonable anticipation of the IIFS would normally not need to be cushioned, as profit-sharing investment account "depositors" would share the losses attributable to the assets (or the proportion of assets) financed by their funds.

In light of the above, the PER and investment risk reserve (IRR) may be considered in terms of the perspective of dealing with expected and unexpected losses to the extent that funds in these reserves provide cushions similar to capital. Pricing designed to cope with expected losses should limit the need for a PER to addressing errors in setting pricing and other such unexpected events. Similarly, the IRR could address unexpected losses (excluding those due to misconduct or negligence), as pricing would be expected to generate resources to fund provisions for expected losses. Investment account deposits, PER, IRR, and capital could usefully be considered within a comprehensive risk management framework in order for IIFS to best calibrate their economic capital, strengthen their ability to compete, and maintain stability.

#### 5. CONCLUSION

The chapter argues for developing and implementing risk management approaches and methodologies for IIFS. Whether for the latter or CFSs, capital is both a core input for business development and a sustainability cushion against the consequences of unexpected adverse events. This double perspective entails a tradeoff in identifying the level and composition of capital a financial intermediary maintains. An over-emphasis on stability may stunt the intermediary's vibrancy, while too much focus on business development may eventually jeopardize stability.

The evolution of regulators' and market participants' thinking is leading them increasingly to take more account of the intermediary's risk profile and tolerance in assessing capital requirements. Technical innovations are allowing both to make professional progress in this direction. These developments are giving them better ways to calibrate the level and composition of capital requirements to balance more efficiently requirements of market development and

stability. IIFS cannot but gain in developing and adopting sound advanced risk management methodologies. They would allow them not only to achieve their business objective of profitability more easily, but also to cope better with the discipline which markets impose, as well as to conduct a beneficial and constructive dialogue with regulators.

Seeking to implement improved risk management practices entails as a first step an effort to identify clearly the risk categories an IIFS may face. These would then need to be translated into variables representing the occurrence of the risk events and the losses these may entail. Some probability distribution would then be associated with each category of risk to provide a framework for assessing the likelihood and extent of losses that may occur. Such a framework would also allow the IIFS to conceptualize the economic capital that corresponds to a level of risk tolerance. It would also provide an approach to setting pricing policies that would incorporate the losses that can be expected in the normal conduct of business.

Implementing a framework incorporating the foregoing features entails the availability of loss data that reflect their historical occurrences within given time periods. The richer the data set in terms of number of observations and their categorization, the better informed the risk management framework can be, the better the pricing policy and the more efficient the identification of the level and composition of capital. Accordingly, IIFS (like other banks seeking to develop an IRB approach and other sophisticated risk measurement techniques) need to put in place data management systems to collect and process loss data. However, collecting a data set sufficiently large to provide robust inferences on the actual risk the IIFS faces may take some time. An option would be for IIFS to join efforts and pool data sets to accelerate the process of improving their risk management practices. In parallel, IIFSs would be investing in enhancing the risk management skills available to them.

IIFS are already engaged in strengthening their stability and competitiveness through improvements in risk management capabilities. Over time, these efforts should enable IIFS to reach assessments of their capital requirements that would permit them to use their resources efficiently and to offer services that contribute effectively to the development of the communities they want to serve.

#### **ENDNOTES**

- \* The findings, interpretations, and conclusions expressed in this chapter are entirely those of the authors. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent.
- 1 See Honohan (2004) and Levine (2004).
- <sup>2</sup> Sir John Hicks identifies such liquidity as one of the main factors behind the Industrial Revolution.
- 3 Actually, a deposit can be viewed as a purchase of a debt asset issued by the intermediary and redeemable at its face value.
- The institution-market competition is reflected in the trends of their relative marker shares of total financial assets. For example, in the United States, between 1960 and the early 1990s, commercial banks' share of total financial intermediaries' assets fell from around 40% to less than 30%. See Edwards (1996).
- They do respond to a latent demand for financial services that do not breach Shari'ah principles. Accordingly, they have the potential to contribute to financial deepening, economic growth, and social inclusion. See also Burghardt and Fuss (2004).
- 6 Modigliani and Miller (1958).
- 7 See Klingebiel and Laeven (2002).
- 8 Views differ on the need for and extent of regulation, as well as on the usefulness of deposit insurance; see Barth et al. (2006).
- 9 Diamond and Rajan (2000).
- 10 Allen and Gale (2004).
- 11 Berger and Bouwman (2005).
- 12 By the "materiality" of financing transactions is meant that, in such transactions, capital must be "materialized" in the form of an asset or asset services (as in murababab credit sales, salam and istisna'a financing, or ijarab leasing), or of a business venture (musharakah or mudarabab). Capital in the form of money is not entitled to any return, as this would be interest (riba).
- 13 See Bessis (2002) for a thorough treatment of risk management in banking.
- 14 See also El-Hawary et al. (2004).
- 15 IIFS may use an external benchmark such as LIBOR to determine the mark-up in murababah contracts. Since the mark-up may be tied to LIBOR, changes therein would have an impact on the value of the murababah contract held by the IIFS.
- 10 Igbal (2005).
- 17 "Principles for the Management of Credit Risk," Basel Committee on Banking Supervision, Basel (September 2000).
- <sup>18</sup> From Khan and Ahmed (2001). They present a survey of risk management of 17 Islamic financial institutions in 10 countries and rank risk perceptions.
- 19 The three pillars are: minimum capital requirements, supervisory review, and market discipline.
- 20 Sundararajan (2005).
- 21 Tier 2 capital is limited to 100% of Tier 1 capital,

- The IAH share of the PER and the whole of the IRR (none of which is attributable to shareholders) are excluded from capital. They are taken into account in measuring the amount of risk-weighted assets attributable to investment account holders. For a discussion of some issues raised by the use of the PER and IRR, see Archer and Karim (2006).
- Sundararajan (2005), See also Archer and Karim (2006).
- Their ability to identify and quantify risks has become crucial for their own profitability and stability, as evidenced by the failure of Barings bank, Singapore, where failure can be attributable notably to weak risk measurement techniques, among other things.
- 25 www.erisk.com/Learning/EconCap/econcap1.asp.
- <sup>26</sup> www.fdic.gov/regulations/examinations/supervisory/insights/ siwin04/economic\_capital.html.
- 27 Financial intermediaries would also use other off-balance sheet methods such as insurance to manage the risks of losses.
- 28 PER cannot be used to offset an overall loss during a period, as this would contravene the Shari'ah; IRR is used for this purpose. PER is employed to enhance the distributable profit if the profit earned is considered inadequate, and this may be due to the effects of asset write-downs or write-offs.

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# Inherent Risk: Credit and Market Risks

Abdullah Haron and John Lee Hin Hock

## 1. INTRODUCTION

The robust growth of the Islamic financial industry in recent years has led to much debate over regulatory issues. A number of corporate scandals have highlighted the importance of sound corporate governance and risk management procedures, and the Islamic finance world is not beyond scrutiny. To ensure effective risk management, conventional banks strive to abide by the Basel frameworks, in existence since the late 1980s. However, Islamic financial institutions may need complementary guidance in the management of the risks inherent in their operations, particularly relating to the specificities of Shari'ab-compliant products and services.

## 2. THE DIFFERENCE IN RISKS

Institutions offering Islamic financial services (IIFS) are predicated on different foundations from conventional financial institutions, in the sense that (over and above general considerations of business ethics) for IIFS profit seeking must take second place to conformity with the rules and principles of the Shari'ah as set out in Fiqh al Muamalat, Islamic commercial jurisprudence that has been developed on the basis of the Qur'an and the Hadith. These dissimilar roots give rise to contrasting risk profiles.

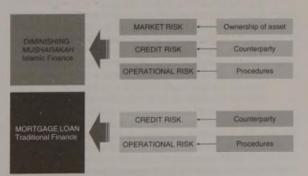
In particular, IIFS are required to abide by the following principles:

 the promotion of fairness in transactions and the prevention of exploitative relationships

- the sharing of risks and rewards between principals in a transaction
- the need for transactions to include elements of materiality leading to a tangible economic purpose (the prohibition of interest)
- · the sanctity of contracts, which should be upheld
- the prohibition of financing of activities that are haram, such as the production and sale of alcoholic beverages or pork meat, and gambling.

Because of the prohibition of interest-based products, financial institutions organized along these lines bear a resemblance to asset management companies as opposed to conventional banking institutions, being co-investors and partners rather than providers or depositors of funds. Consequently, Islamic modes of financing – such as the *murabahah* (where the financier acts as a passive partner, shares the profits with the active partner, and bears any losses) and the profit- and loss-sharing *musharakah* – display distinct risk characteristics that must be accounted for in capital adequacy requirements and risk management frameworks for IIFS. An example of the distinct risk characteristics displayed by Islamic financial products is given in Exhibit 5.1.

EXHIBIT 5.1 Home financing through Islamic and conventional financing schemes



# 3. INHERENT RISK IN ISLAMIC FINANCIAL INSTITUTIONS

# 3.1. Credit Risk

The possibility of counterparties not fulfilling pre-determined obligations is as distinct a risk to IIFS as to conventional financial institutions. An IIFS, like a conventional financial institution, deals similarly with counterparties who, at the outset of a contract, have agreed to meet stipulated terms. However, as with a conventional financial institution, there is the prospect that these counterparties will not meet these terms.

In general, the IIFS is exposed to the following credit risks:

- Murababah: The IIFS is exposed to credit risk following the exchange of the products between the IIFS and a customer. It is a settlement risk/default risk whereby the customer may not be able to honor the payment obligation (loss of receivables).
- 2. Salam: The IIFS is exposed to the settlement/delivery risk where goods are not delivered, or not delivered on time, or not according to specification by the seller/customer after payment is made (loss of invested amount). Another scenario is that the IIFS may not be able to recover its capital from salam customers fully; or claims against urboun<sup>1</sup> or a financial guarantee are not sufficient to cover the whole amount of salam capital (loss of invested capital).
- Istisna'a: The IIFS may risk facing the customer who is unable
  to honor the payment obligation for deferred installments or
  progress billings (loss of amount receivables) when the work
  is already in progress.
- 4. Istisna'a with parallel istisna'a: The IIFS may be exposed to completion risk in the parallel istisna'a, when an advance payment has been made by the IIFS and the sub-contractor does not complete the work. The situation is greatly aggravated if no other sub-contractor is available as a replacement. Such a situation leads to risks in the direct istisna'a according to which the IIFS has an obligation to the ultimate customer. In addition, payments made by the IIFS to the sub-contractor may not be recoverable.
- Operating ijarah and ijarah muntahia bittamleek (IMB): The customer (lessee) may be unable to service the lease rental as

and when it falls due, and thus defaults on this obligation. In principle, the IIFS as lessor has the right to repossess the leased asset if the lessee defaults, thus mitigating the credit risk. However, particularly in the case of IMB, there may be difficulties in exercising this right.

- 6. Musharakah: The IIFS is exposed to the risk of losing its entire invested capital in musharakah financing or investment, since such capital may not be recovered as it ranks lower than debt instruments upon liquidation. In a different situation, an IIFS may face a risk when a withdrawing partner owes monies to the IIFS (loss of invested capital).
- Mudarabah: The IIFS is exposed to capital impairment risk if the venture being financed incurs losses, or if the mudarib defaults on payments due to the mudarabah.

## 3.2. Market Risk

Market risk is the risk of losses in on- and off-balance sheet positions arising from market prices. Conventional financial institutions are exposed to these risks from the positions they hold in financial instruments. These positions are held, among other objectives, intentionally to secure a short-term profit from price or interest-rate variations or to hedge against other elements of the trading book.<sup>2</sup>

However, IIFS are forbidden from earning returns from speculative transactions, and contracts connected to the incidence or non-incidence of future events, such as hedging or other derivatives, are disallowed. But IIFS are exposed to market risk in a unique manner. The Shari'ah principles, to which these institutions adhere, include the notions of materiality in transactions and the sharing of risk and rewards. As a result, IIFS carry out many asset-based transactions in which they take ownership of physical assets as co-investors. This setting exposes them to market risk – as the asset price may fluctuate.

In an IIFS, market risk exposures result from, for example:

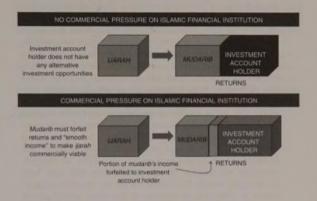
Non-binding murabahah for the purchase orderer (MPO): If
a customer cancels the agreement to purchase (AP), the IIFS
has to sell the goods in the open market at a selling price
that can be lower than the purchase price. The IIFS may have
to devote resources to marketing efforts in order to sell the
cancelled purchase goods, or have to dispose of the asset at

- a loss. Alternatively, IIFS may have to hold the goods and incur additional costs, such as warehousing, insurance, or even damages (if the goods are perishable in nature).
- Salam: Since salam is a forward purchase of goods, upon signing the contract the IIFS is exposed to price risk on the goods (that is, the spot price on delivery may be lower than the amount paid).
- 3. Salam with parallel salam: If the supplier under the salam defaults on delivery, the IIFS may have to purchase the goods in the open market in order to meet its delivery obligation under parallel salam. Apart from the credit risk (exposure to loss in respect of the obligation of the defaulting supplier), the IIFS is also exposed to price risk, as the open market price that has to be paid may exceed the amount paid under the salam contract.
- 4. Istisna'a with parallel istisna'a: If the customer under a direct istisna'a defaults on the contract and the IIFS has to find another purchaser for the asset, it is exposed to a price risk namely, that a purchaser can be found only for a price lower than the original contract price. In principle, any such loss should be recoverable from the defaulting customer, but such recovery may be problematic (for example, the customer may claim justification in cancelling the contract).
- 5. Operating ijarah and ijarah muntahia bittamleek (IMB): When the customer opts not to fulfill a non-binding agreement to lease, and the IIFS has already acquired the asset (or placed a non-cancellable order for it), it may have to lease (or sell) the asset at a lease rental (or a selling price) lower than the originally agreed total rentals (or selling price) to the original customer. This represents another form of price risk.
- Operating ijarah: The IIFS will bear the potential loss due to the fair value of the asset falling below its residual value as estimated at lease inception (residual value risk).

# 3.3. Displaced Commercial Risk

The notion of displaced commercial risk is peculiar to IIFS. In certain situations, the IIFS will be commercially compelled to increase the rate of return to its investment account holders to persuade them to keep their funds in the financial institution. Thus, it will give up some

EXHIBIT 5.2 Income smoothing and displaced commercial risk



portion of its share of profits as *mudarib*; the rate of return to the client is "smoothed" at the expense of profits normally attributable to the IIFS's shareholders, as illustrated in Exhibit 5.2.

Usually this displaced commercial risk is a result of rate of return risk. This occurs when funds are placed in assets such as murabahah or ijarah, with a long term of maturity, and the rate of return is no longer competitive with alternative investments. Although in theory IIFS are not obligated to carry out such income smoothing, they may find that due to supervisory authority or commercial pressure, they are virtually forced to do so.

Integral to the overall risk management process is an understanding of the risk inherent in the operation of IIFS. The process should be comprehensive and should include external factors that may have an impact on the risk management process, and should be dynamically updated since the risk environment is constantly changing.

Due to the effect of Shari'ah rules and principles, the following premises add a unique dimension to risk management in IIFS.<sup>5</sup>

 The role of the IIFS may embrace those of a financier, a supplier, a mudarib, and a musharakah partner. Hence, IIFS are exposed to the risks of not receiving deferred payment or deferred delivery, and of having to make or take delivery of a physical asset.

- The commencement of credit risks underlying various financing modes varies according to the recognition of the binding or non-binding nature of some contracts (such as murabahah) or the transformation of investment accounts into debt in the case of proven negligence or misconduct of the mudarib or a musharakah's managing partner.
- The prohibition from imposing any penalty for delayed payment, except in the case of deliberate procrastination, results in the IIFS being unable to use conventional debt recovery techniques. This may enhance the importance of using guarantees or collateral as credit risk mitigants. In addition, there are restrictions on the use of conventional derivatives such as credit default swaps, and on the availability of Shari'ahcompliant alternatives. In this context, the IIFS may have no financial remedy for default except for recourse to guarantees or collateral, or liquidation and other administrative measures.

Since IIFS employ a number of financing modes, the review of inherent risk in the IIFS balance sheet requires that the risk assessment process be structured in a matrix format. For each financing mode, the initial step would be to review each stage on one side and the exposures to credit and market risks on the other side.<sup>6</sup> An overview of risk exposures in each financing mode is tabulated in the appendix to this chapter.

# 4. CONCLUSION

Certain risks may be considered as being inherent in the operations of both Islamic and conventional financial institutions. Although the risk exposures of an IIFS differ in some respects from, and may be more complex than, those of a conventional financial institution, as noted above, the principles of credit and market risk management are applicable to both. The IFSB's standards on capital adequacy and risk management guiding principles mark the first steps in an ongoing process of developing prudential standards and filling regulatory gaps in the field of Islamic finance.

These seminal documents expand upon the Basel framework where the latter is insufficient to cater for the specificities of Islamic financial institutions. It is important to note, however, that the IFSB standards illustrate how the broad principles behind the Basel framework may be applied to the Islamic financial industry. This applicability, though, is subject to these principles being customized and fine-tuned to the specificities of Islamic finance.

This commonality between the Islamic and conventional finance spheres presents a stumbling block for those who believe that the Islamic financial institution is an exotic beast from the "Middle East." These standards and guidelines crafted by the IFSB are likely to mark the beginning of the further integration of Islamic finance into the wider conventional financial sphere.

marketing efforts to

## APPENDIX: INHERENT CREDIT AND MARKET RISKS ASSOCIATED WITH THE FINANCING MODE

# 1 MURABAHAH FOR THE PURCHASE

Stage	Application and principles	Credit risk	Market risk
Agreement to purchase (AP)	A customer enters into a verbal agreement or memorandum of understanding (agreement to purchase, or AP) with an IIFS, requesting the IIFS to purchase a specified kind of goods		
	with an agreement to repurchase.		
	The AP specifies:		
	detailed specifications of the goods unit     supplier (this is optional).		
	The AP can be binding or non-binding, depending on the views of the Shari'ah board.		
	Principal and agent relationship The IIPS obtains price quotations from suppliers or appoints a purchasing agent (agent). The IIPS executes an agency contract with the agent.		
	The goods must be purchased from a third party and not from the customer or his agent/company. However, the goods can be purchased from a party who has a blood/marital relationship		Price risk (non-binding MPO) If the customer cancels the AP, the IIFS has to set the goods in the open market at a selling price that can be lower than th purchase price. The IIFS may require/intensify

with the customer.

Stage	Application and principles	Credit risk	Market risk
			sell the cancelled
			purchase goods (low asset price).
	The offer for sale by the		Alternatively, the
	supplier (can be in the		IIFS has to hold the
	form of an invoice)		goods and incur
	must be addressed to		additional costs,
	the IIFS and a sale is		such as
	concluded once the offer		warehousing,
	is accepted by the IIFS.		insurance, or even
			damages (if the
	The supplier delivers		goods are perishable
	goods to the IIFS. The		in nature).
	IIFS takes possession, or		
	"constructive		Risk mitigation
	possession," of the		The IIFS can
	goods and subsequently		purchase goods on a
	offers goods for sale to		"sales return" basis.
	the customer.		
			The IIFS can request
	The contract cannot		a "Hamish
	stipulate that the		Jiddiyyah," or a
	ownership of the goods		security deposit.
	be transferred upon full		This is normally
	payment of the selling		required in the case
	price.		of a binding
			promise.
	A constructive		
	possession can take		
	place by, inter alia,		
	having the goods placed		
	at the IIFS's disposal,		
	receipt of bill of lading		
	by the IIFS or its agent,		
	or receipt of certificates		
	of storage issued by the		
	warehouse.		
	The IIFS is responsible		
	for the risks associated		
	with the goods and is		
	liable for any defects		
	from this point		
	onwards.		
Asset is sold and	The IIFS and customer		Settlement
delivered to a	execute a murababah		risk/default risk
customer	contract if the customer		The customer may
	agrees to purchase the		not be able to honor
	goods.		the payment (loss of
			receivables).

Stage	Application and principles	Credit risk	Market risl
1 610	The following Shari'ab principles must be met for the contract to be valid:  The goods are in existence at	Risk mitigation The IIFS may request an urboun, a third party financial guarantee, or pledge of assets,	
	the time of sale.  Ownership of the goods must be with the seller/IIFS.  The goods are in possession or constructive possession of the seller/IIFS.	Direct debit from the customer's account, centralized blacklisting system, and penalty helps to deter the customer's late payment behavior. Some Shari'ah scholars consider charging a compensation fee.	
	The goods must have a commercial value. The goods are not to be used for a "baram" purpose. The goods must be specifically identified and known. The delivery of goods is certain and not conditional upon certain events. The selling price is fixed at cost		
Maturity of contract erm	plus mark-up or profit.  The customer settles the full amount of the selling price to the IIFS.		

# 2. SALAM (AND PARALLEL SALAM)

Stage	Application and principles	Credit risk	Market risk
Payment of purchase price	The customer as the seller, and the IIFS as the buyer, execute a sulam contract or a salam master agreement (to be followed by execution of multiple Salam contracts).		Commodity price risk Salam is a forward purchase of goods. Upon signing the contract, IIFS is exposed to price risk of goods (low asset value).
	The contract is binding and cannot be cancelled unilaterally. The contract specifies:		Risk mitigation The IIFS enters into a parallel salam. <sup>T</sup>
	type of goods to be delivered by the customer, or "al-muslam fibit" quantity date, place, and manner of delivery basis for determining the price mode of payment.		
	Payment of salam capital The IIFS pays capital of salam to the seller/customer when the contract is executed. Some Shari'ah scholars allow delayed payment of 2–3 days after the contract date.	Settlement/delivery risk Goods are not delivered, or not delivered on time, or not according to specification by the seller/customer after payment is made (loss of invested amount).	

Stage	Application and principles	Credit risk	Market risk
	The capital of salam can be in the form of cash, fungible goods, or "usufruct." For salam, capital in the form of fungibles must specify its kind, type, specifications, and quantity.	Risk mitigation The IIFS may request a performance guarantee from the customer to give assurance on the delivery of goods or a pledge of goods.	
Receipt of the purchased goods	Goods delivered which are not within the specifications can be rejected by the IIFS. <sup>8</sup>	Capital recovery risk The salam capital cannot be recovered fully; or claims against urboum or a financial guarantee	Asset replacement risk (for salam with parallel salam) The IIFS has to purchase goods from the open
	If the seller cannot deliver goods due to insolvency, the seller can be granted an extension of delivery.	due to cover for the whole ne seller amount of salam	market in order to meet its delivery obligation under parallel salam. The IIFS is exposed to a higher price.
	Cancellation of delivery of goods is allowed in return for repayment of salam capital on portions that are yet to be delivered.		mgare prince
Maturity of contract term	The customer delivers goods of a specified kind and quality to the IIFS on the agreed date. <sup>9</sup>		Commodity price risk (salam without parallel salam) Upon receiving the goods, the IIFS is exposed to price risk of goods (low asset value).

# 3. ISTISNA'A AND PARALLEL ISTISNA'A

Stage	Application and principles	Credit risk	Market risk
Contract	The customer	Settlement risk	Price risk (of
(unbilled	executes an	The customer is	cancelled
work-in-process	istisna'a contract	unable to honor the	ordered goods)
inventory)	with the	payment for	If the customer
The IIFS may	manufacturer	deferred installment	of a direct
enter into a	(the IIFS)	or progress billing	istisna'a cancels
parallel istisna'a	requesting the	(loss of amount	the contract, the
contract with a	latter to	receivables).	IIFS continues to
sub-contractor to	construct or		manufacture the
manufacture the	manufacture a	Risk mitigation	goods until
goods ordered.	specified type of	The IIFS may secure	completed and
The IIFS may be	goods.	urboun, or money in	sells to a third
required to give a		advance, prior to	party at a price
guarantee to the	The contract	commencing the	that can be lowe
sub-contractor.	specifies:	work.	than the original
	specimes.	WOLE.	contract price
The parallel	The second	Completion wish	(loss asset
isfisna'a contract	• type of	Completion risk (parallel istisna'a)	value). 10
must be	goods to be	When an advance	varue),
independent of	manufac-	payment has been	Risk mitigation
the istisna'a	rured/		The IIFS may
contract. The	constructed	made by the IIFS,	
IIFS assumes the	by the IIFS	the sub-contractor	request an urboun, which
	<ul> <li>price (which</li> </ul>	does not complete	can be deducted
liability of	can be paid	the work (and the	
ownership risk	fully in	situation is	from the selling
plus maintenance	advance, in	worsened if there is	price if the
and insurance	deferred	no other	contract is
expenses.	installments,	sub-contractor to	fulfilled or forfeited if the
	or apon full	replace them) and in	
	completion)	turn poses some	contract is
	<ul> <li>date, place,</li> </ul>	risks to direct	rescinded.
	and manner	istisna'a.	and the same
	of delivery		The IIFS may
	<ul> <li>mode of</li> </ul>	Recovery risk	enter into
	payment	Capital is	parallel
	(cash,	irrecoverable from	istisna'a.11
	tangible	the sub-contractor,	
	goods, or		
	usufruct of	Risk mitigation	
	an asset for	The IIFS can secure	
	a specified	a performance	
	duration).	guarantee from the	
	and a second	sub-contractor.	

Stage	Application and principles	Credit risk	Market risk
	Goods delivered that are not within the specifications can be rejected by the buyer or be accepted by the buyer as it is, with or without a price discount.	*	
	If goods delivered are within or of higher quality, the buyer is obliged to accept unless a higher price is demanded by the seller (in the case of higher quality of goods being delivered).		
	If the goods are ready but the buyer delays in taking delivery, the goods in the possession of the IIFS will be on a trust basis and the IIFS is not liable for any loss or damages unless at the negligence and misconduct of the IIFS.		-
Maturity of contract term	The IIFS delivers completed goods to customers.		
	When the buyer delays in taking delivery of the completed goods, the IIFS can sell the goods to a third party to recover its contract price and return the		
	balance if any or have a recourse against the buyer if not sufficient.		

# 4. OPERATING IJARAH AND IJARAH MUNTAHIA BITTAMLEEK (IMB)

Stage	Application and principles	Credit risk	Market risk
Agreement to lease (AL) (binding)	When a customer requests the IIFS (the lessor) to purchase a specified asset.		
	A customer enters into a memorandum of understanding (agreement to lease, or AL) with an IIFS, requesting the IIFS to purchase a specified kind of asset with a promise to lease.		
	The IIFS should first purchase the asset prior to execution of an <i>ijarah</i> contract.		
	The IIFS takes possession or "constructive possession" of the assets and subsequently offers the asset for lease to		Price risk When the customer opt not to fulfill the promis or agreement to lease, the IIFS has to lease (or sell) at lease rentals (or a selling price) that can be lower than the
	the customer.  The IIFS is responsible for the risks associated with the asset.		original total rentals (or selling price) to the original customer (low asset value).
			Risk mitigation The IIFS requests a "Hamish Jiddiyyah," or security deposit, to guarantee the custonite's commitment to lease the asset. The IIFS can deduct the difference between

Stage	Application and principles	Credit risk	Market risk
			lease rentals (or a selling price to a third party) and cost of the asset when the customer breaches the AL.
Upon consigning a leasing contract	The customer (as lessee) executes an ijarab contract with an IIFS (as lessor) requesting the lessor to:  • acquire an asset; or • acquire the usufruct of an existing asset which the customer wishes to take on lease.  The contract can be drawn via a master agreement (to be followed by execution of multiple confirmations of offer and acceptance of individual ijarah transactions) or individual contracts.  The contract is binding and cannot be cancelled unilaterally.  The lease period should commence from the date of execution unless the patties agreed on a specified future commencement date.	Settlement risk The customer is unable to service the lease rental as and when it falls due.  This inability can be due to variable lease rentals that may distress the customer's ability to pay (loss of rental receivables).  Risk mitigation The IIFS can request an urboun from the customer and deduct for damages. The urboun can also be taken as an advance payment of the lease rental.  Alternatively, the IIFS as the owner has the right to repossess the assets.	Benchmark risk Long-term ijarah with fixed rental is susceptible to changes in market conditions – e.g. higher return demanded by investors (low investment return).  Risk mitigation Renewable short-term leases with price tre-fixing subject to mutual consent, or adopts variable lease rentals which are determined according to a certain benchmark.

Maturity of

contract term

Application and Stage principles Credit risk Market risk (future ijarah). Future ijarab is allowed provided that the lease rentals are payable by the lessee after the leased asset is delivered to the lessee. The contract should specify: The usufruct to be transferred to the lessee for an agreed period at an agreed consideration. The leased asset must have a valuable use. The leased asset must be fully identified by the contracting parties. The purpose or intended use of the leased asset by the lessee must be lawful/Shari'abcompliant and in the normal course of urilization. (A. purpose that is not within the normal course requires consent of the lessor.) The lease rental must be determined at the time of contract for the whole period of the lease.

> The asset is returned to the IIFS.

Stage	Application and principles	Credit risk	Market risk
	In the case of IMB,		Residual value risk
	the lessor is unilaterally binding	,	(operating ijarah only)
	to transfer		The IIFS will bear
	ownership in the		the potential loss
	leased asset to the lessee.		of the asset falling below its residual
	The option to transfer legal		value estimated at lease inception (low
	title/ownership of		fair value).
	the leased asset must be documented		
	separately from the		
	ijarah contract and		
	be effected via one		
	of the following methods:		
	• gift		
	token     consideration		-
	final installment     of lease rental		

### 5 MUSHARAKAH

Stage	Application and principles	Credit risk	Market risk <sup>12</sup>
Contract	The partners execute a partnership (musharakah) agreement that specifies:  offer and acceptance the contracting parties the capital amount and structure the profit-sharing ratio. (The ratio can be amended from time to		
	ctime.)  Capital  The capital can be in the form of cash, gold, silver, or their equivalent in value and tangible assets.  Debt (receivables) alone is not permissible as the	Capital impairment risk The musharakah capital may not be recovered, as it ranks lower than debt instruments upon liquidation.  Risk mitigation A third-party guarantee can be obtained for the loss of capital	
	capital unless the debt is inseparable from other assets that can be presented as a contribution to the capital. Funds in current accounts can be withdrawn as contribution to the capital.  A partner cannot guarantee the capital of another partner.	of some or all partners, provided that:  the legality and financial liability of the guarantee is independent from the contract  the guarantee is not linked in any manner to the contract  the third-party guarantor should not own more than 50% equity in the entity to be guaranteed  the guaranteed entity should not own more than should not own more than the guaranteed.	

Stage	Application and principles	Credit risk	Market ris
stage		Credit risk	Market risi
	Management		
	The management of the	*	
	musbarakah can be		
	restricted to certain		
	partners or a single partner.		
	A fixed remuneration to		
	such "managing" partner(s) is not allowed, but the		
	partner(s) can earn a greater allocation of profit		
	share at a ratio higher than		
	its share of capital.		
	its snare of capital.		
	A manager other than the		
	partner(s) can also be		
	appointed to manage the		
	musharakah at a fixed		
	remuneration and a profit		
	share, if any.		
	Profit-loss sharing		
	The profit allocation is		
	calculated net of operating		
	costs, expenses, and taxes.		
	The profit allocation can be		
	equal to the invested capital		
	ratio, or different, as agreed		
	between the partners		
	provided that the "sleeping		
	partner" is not entitled to		
	more than its invested		
	capital ratio.		
	The profit share cannot be		
	stated in a lump sum or as		
	a percentage of the capital.		
	The profit will be finally		
	allocated from the proceeds		
	of selling the existing assets		
	(actual valuation) or based		
	on valuation of assets at		
	fair value (constructive		
	valuation). The allocation		
	of profits must be based on		
	actual profit.		

Stage	Application and principles	Credit risk	Market risk
	Profits can be carried forward and set aside, subject to the provisions of articles of association of the musharakah, as reserves.		
	The loss shall be borne periodically by the respective partners in accordance with their contribution of capital. It is not permitted to hold one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership. However, a partner can take responsibility to bear the loss without any prior condition.		
Early termination	A partner can withdraw from the partnership at any time by giving notice to this effect unless in the contract it has explicitly stated that the partnership is to survive for a fixed period whereby termination prior to the agreed expiry date of the musharakah is not allowed.		
	The partners can unanimously agree to terminate the partnership prematurely.		
	The withdrawal of a partner does not necessitate the termination of the whole partnership.		
	A partner can enter into a binding promise to buy, at any time, all the assets of the musbarakab based on market value as at the acquisition date.		

Stage	Application and principles	Credit risk	Market risk
	Diminishing musharakah A partner is allowed to give a promise to buy the equity share of the other partner gradually until the title to the equity is completely transferred. This promise must not be stated in the musharakah contract and must be stated in a separate buying and selling agreement.	Cointerparty risk Occurs when the withdrawing partners owe monies to the IIFS (loss of invested capital).  Risk mitigation The IIFS is able to buy-in the withdrawing partner's share or to find a new partner to take it over.	
Maturity of the contract term	On maturity, the assets are liquidated (sold) or by way of constructive liquidation (valuation). The assets shall be sold at current market values and the proceeds will be utilized for payments in the following order:		
	liquidation expenses     financial liabilities     from the net assets     distribution of the     remaining assets     among the partners in     accordance with the     invested capital ratio,     or if they fall short, on     a pro-rata basis to the     invested capital ratio.		

Person	Application and		
Stage	principles	Credit risk	Market risk
Contract	Capital		
	The mudarabah capital		
	must be in the form of cash		
	or tangible assets that are		
	valued by the experts. The		
	capital cannot be in the		
	form of debt owed by the		
	mudarib or another party		
	to the capital provider.		
	The capital must be freely		
	accessible to the		
	mudarib/customer for the		
	mudarabah contract to be		
	valid. A mudarih invests		
	the mudarabah capital on a		
	trust basis; hence, it is not		
	liable for losses except in		
	cases of misconduct,		
	negligence, and breach of		
	the terms of the mudarahah		
	contract whereby the		
	mudarib becomes liable for		
	the amount of the capital.		
	Profit allocation		
	The profit allocation ratio		
	and its calculation		
	methodology must be		
	clearly stated. The profit		
	ratio must be on the basis		
	of an agreed percentage of		
	the profit and not in a lump		
	sum or a percentage of the		
	capital. However, the lump		
	sum profit is allowed when		
	both parties agreed in the		
	contract to distribute a lump sum profit if it		
	exceeds a certain ceiling of		
	profit.		
	pront		
	The profit allocation ratio		
	should be determined when		
	the contract is concluded		
	and the ratio can be		
	changed any time.		

Stage	Application and principles	Credit risk	Market risk
Stage	The mudarib cannot earn any fee in addition to the profit, as the work is part of his or her responsibilities. The mudarib is not allowed to make a loan, gift, or donations out of the mudarib funds. The mudarib is entitled to claim for traveling expenses based on standard practice or expenses up to the amount allowed by the capital provider.  Profit can only be claimed when the mudarabah operations make a profit. Any losses must be compensated by profits of future operations. If the losses are greater than profits at the time of liquidation, the net loss must be deducted from the capital, which is borne solely by the capital provider.	Capital impairment risk Loss-making operations may expose the IIFS to the risk of capital erosion.	Market risk
	If the mudarib commingles its own funds with the mudarabab funds, the profit earned on both funds shall be divided proportionately to the amounts of the two funds.		
	The mudarib may also combine the mudarabab funds with musbarakab funds, or accept funds from a third party on a mudarabab basis, subject to the capital provider's permission or by appointment.		
Early ter- mination	Termination can be done by either party as it is a non-binding contract, by mutual agreement,		

Stage	Application and principles	Credit risk	Market risk
	when mudarabah funds have been exhausted or suffered losses, or upon death or liquidation of the mudarib.		
Maturity of the contract term	Interim profits can be distributed on account as long- as the mudarabab operations are profitable, subject to actual valuation or construction valuation for the final distribution.		
	The final allocation of profit can be based on the selling price of mudarahah assets (actual valuation) or valuation of assets on the fair value (constructive valuation) whereby receivables are valued at cash equivalent or net realizable value (i.e. net of a provision for doubtful debts).		

#### **ENDNOTES**

- Earnest money held after a contract is established as collateral to guarantee contract performance.
- <sup>2</sup> "Amendment to the Capital Accord to Incorporate Market Risks," Basel Committee on Banking Supervision, January 1996.
- <sup>3</sup> Andrew Cornford, "Capital of Alternative Financial Institutions and Basel II: Credit Cooperatives and Islamic Banks," *Third International Meeting: Ethics, Finance and Responsibility*, Geneva, Switzerland, October 2004.
- <sup>4</sup> Dr. Sabir Mohamed Hassan, "Issues in the Regulation of Islamic Banking (The Case of Sudan)," Research and Studies Series, Bank of Sudan, October 2004.
- FIFSB, "Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services," March 2005, para.
  21.
- Note that the IIFS is also exposed to operational risk but, for the purpose of the discussion in this section, only credit and market risks are mentioned.
- <sup>7</sup> The IIFS can sell goods to a party other than the salam customer (or a company less than one-third of which is owned by the salam customer). The parallel salam contract must be independent of the salam contract. The IIFS's obligation to deliver goods under parallel salam is not inter-conditional on the performance obligations under the direct salam contract.

- 8 If goods delivered are within or of higher quality, the IIFS is obligated to accept unless the seller (in the case of higher quality of goods being delivered) demands a higher price.
- <sup>9</sup> The IIFS may decide not to sell the goods immediately upon receipt; hence, the goods will be exposed to selling price fluctuations.
- 10 Cancellation of contract is allowed as long as the IIFS has not commenced work. Hence, the IIFS is not exposed to price risk.
- 11 The IIFS may enter into a parallel istisna'a contract with a sub-contractor to manufacture the goods ordered. The IIFS may be required to give a guarantee to the sub-contractor. The parallel istisna'a contract must be independent of the istisna'a contract. The IIFS assumes the liability of ownership risk plus maintenance and insurance expenses.
- 12 The types of underlying assets of musharakah may give rise to market risk.



# Operational Risk Exposures of Islamic Banks

Simon Archer and Abdullah Haron

### 1. INTRODUCTION

perational risk is defined in Basel II as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events . . . [including] legal risk . . . but [excluding] strategic and reputational risk." Legal risk, in turn, is defined as including, without being limited to, "exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements."

Cases of operational failures in the financial services industry during the 1990s brought operational risk to attention as an important area for regulation. The operational failures manifested themselves in different activities of these institutions, including failure in risk oversight by senior management, and poor accounting and auditing processes.

Basel II introduced a capital charge for operational risk, using a methodology described below. However, the use of a capital charge for this purpose is somewhat controversial. A major reason for this is that the nature of operational risk is such that measuring it for capital adequacy purposes is problematic (see Chapter 11 in this volume).

# 2. THE BASEL II METHODOLOGY

The Revised Framework presents three methods for calculating operational risk charges "in a continuum of increasing sophistication and risk sensitivity." These are: (i) the Basic Indicator Approach; (ii) the Standardized Approach; and (iii) the Advanced Measurement Approaches. Internationally active banks and those with significant risk exposures are expected by the Basel Committee on Banking Supervision (BCBS) "to use an approach that is more sophisticated than the Basic Indicator Approach and that is appropriate for the risk profile of the institution."

# 2.1. The Basic Indicator Approach (BIA)

This approach uses a gross income as a proxy measure of exposure to operational risk. Hence, it requires banks to hold capital for operational risk equal to the average over the previous three years of a fixed percentage of positive gross income. Years in which gross income is negative are ignored. The proposed percentage is 15%. Gross income is defined (for conventional banks) as "net interest income plus net non-interest income." This measure should: (i) be gross of (a) any provisions and (b) operating expenses, including fees paid to outsourcing service providers (however, fees received for providing outsourcing services should be included); and (ii) exclude (a) realized profits/losses from the sale of securities in the banking book, and (b) extraordinary or irregular items, as well as income derived from insurance.

It will be clear from the above that if any such approach (either the Basic Indicator or the Standardized Approach, which uses similar but more refined proxy measures of operational risk exposure) is to be applied to Islamic banks, gross income needs to be defined so as to reflect the nature of their operations, as discussed in Section 3 below.

# 2.2. The Standardized Approach (SA)

This is a refinement of the BIA in which banks' activities (and gross income) are divided into eight lines of business (LOBs), and the total capital charge is calculated as the three-year average of the simple addition of the capital charges across the eight business lines in each year. A negative capital charge in any one year for one LOB is offset against the positive capital charges for the other LOBs in that year, unless the total for the year is negative, in which case the input for the year to the three-year calculation is zero. The percentage for the different LOBs varies from 18% for corporate finance, trading and sales, and payment

and settlement, through 15% for commercial banking and agency services, to 12% for retail banking, asset management, and retail brokerage.

Basel II also allows a variant of the SA, the Alternative Standardized Approach (ASA), to be used subject to national supervisory discretion. Under the ASA, the capital charges for two LOBs, commercial and retail banking, are calculated using "loans and advances" instead of gross income as the indicators of exposure to which the percentages (15% and 12%, respectively) are applied. Commercial and retail banking may be aggregated into one LOB, in which case the percentage to be applied is 15%.

# 2.3. Advanced Measurement Approaches (AMA)

These approaches, use of which is subject to supervisory approval, allow banks to develop their own proxy measures of operational risk exposure.

## 3. OPERATIONAL RISK IN ISLAMIC BANKS

# 3.1. Operational Risk Exposures in Islamic Banks

In the context of the Islamic financial services industry, appropriate systems, processes, and products are all recent developments. Continued growth in the industry poses a continual challenge in these areas of development, and failures in managing these areas will bring negative consequences.

Operational risks faced by Islamic banks can be divided into three categories:

- (a) Operational risks that are consequential upon various kinds of banking activities, and which are somewhat similar for all financial intermediaries, whether Shari'ah-compliant or not. However, the asset-based nature of financing products in Islamic banking such as murabahah, salam, istisna'a, and ijarah may give rise to forms of operational risk in contract drafting and execution that are specific to such products.
- (b) Shari'ah compliance risk that is: (i) risks relating to potential non-compliance with Shari'ah rules and principles in the bank's operations; and (ii) the further risk associated with the Islamic bank's fiduciary responsibilities as mudarib toward fund providers under the mudarabah form of contract,

according to which in case of misconduct or negligence by the *mudarib* the funds invested by the fund providers become a liability of the *mudarib*. *Shari'ah* compliance risk is the risk of non-compliance resulting from a failure of an Islamic bank's internal systems and personnel that should ensure its compliance with the *Shari'ah* rules and principles determined by its *Shari'ah* board or the relevant body in the jurisdiction in which the Islamic bank operates.

(c) Legal risks arising either from: (i) the Islamic bank's operations (legal risks common to all financial intermediaries); or (ii) problems of legal uncertainty in interpreting and enforcing Shari'ah contracts. (These potentially very significant problems are discussed at greater length in Chapters 7 and 18 of this volume.)

With regard to (a) above, it should be noted that Islamic products tend to be more complex than their conventional counterparts, requiring more processing steps and hence leaving more room for error. Islamic banks typically hold more physical assets on their balance sheets than conventional banks and are exposed to operational risks associated with these. In addition, the operational risks associated with information technology (IT) in Islamic banks may exceed those in conventional banks for which more standardized software is likely to be available.

With regard to (b)(i) above, Shari'ah compliance is critical to an Islamic bank's operations, and such compliance requirements must permeate throughout the organization and its products and activities. As a majority of the fund providers use Shari'ah-compliant banking services as a matter of principle, their perception regarding the Islamic bank's compliance with Shari'ah rules and principles is likely to be of great importance in maintaining their customer loyalty. In this regard, Shari'ah compliance is considered as falling within a higher-priority category in relation to other identified risks (see also Section 4.6(2) below). However, it should be noted that reputational risk, including that relating to Shari'ah compliance, falls outside the Basel II definition of operational risk.

In most jurisdictions, Shari'ah compliance is achieved principally through the mechanism of a separate "Shari'ah supervisory board," which has the responsibility of laying down the Shari'ah principles and rules to which the institution should adhere. The Shari'ah supervisory boards, typically, also advise on any issues surrounding new products

or new structures, approve the wording of any related contract documents, and issue a report (included in the bank's annual report) which attests as to the bank's Shari'ah compliance in its operations during the year covered by the annual report. Such boards satisfy themselves as to proper adherence to the principles and rules laid down through a process of internal and external Shari'ah reviews. The management of Shari'ah compliance risk therefore requires that there should be timely information concerning the Islamic bank's products and operations from the management to the Shari'ah supervisory board. Since the industry is growing at a rapid pace, the requirement for expertise in Shari'ah aspects in various departments is a significant factor (see, for example, Chapter 20 in this volume). Inadequately trained staff will expose the Islamic bank unnecessarily to such operational risks, including the risk of income not being recognized as permissible when there is a failure in Shari'ah compliance.

As for (b)(ii) above, fiduciary risk is the risk that arises from an Islamic bank's potential failure to perform in accordance with explicit and implicit standards applicable to its fiduciary responsibilities, especially in its role as mudarib. As a result of losses on investments, an Islamic bank may become insolvent and therefore unable either (a) to meet the demands of current account holders for repayment of their funds, or (b) to safeguard the interests of its investment account holders (IAHs). An Islamic bank may fail to perform due diligence or to act with sufficient prudence when making and managing investments, resulting in risks of foregone profits or of losses to its IAHs.

# Capital Requirements for Operational Risk in Islamic Banks

The Islamic Financial Services Board (IFSB) has set out capital requirements for Islamic banks in its Capital Adequacy Standard. These requirements are based on the Basic Indicator Approach, with gross income being redefined in an appropriate manner as indicated below, and 15% being used as the standard percentage. As the LOBs into which IIFS are organized are different from those set out in Basel II, the IFSB proposes that, at the present stage, the Basic Indicator Approach be used by Islamic banks. However, subject to the supervisory authority defining the applicable LOBs, it may allow Islamic banks in its jurisdiction to apply the Standardized Approach in which the percentage (12%, 15%, or 18%) of gross income is to be set aside according to the LOB.

Gross income is defined as the sum of:

- (a) net income from financing activities (e.g. selling price less purchase price in murabahah and salam, lease rentals in ijarah), gross of any provisions and operating expenses and of depreciation of ijarah assets
- (b) net income from investment activities
- (c) fee income (e.g. commissions and agency fees)Less:
- (d) IAHs' share of income.

Net income from financing activities under (a) includes both the share of IAHs and the Islamic bank's share as *mudarib* and as a co-investor with IAH in commingled asset pools (as is normally the case with unrestricted IAHS). The IAHs' share of such income is deducted under (d).

Gross income excludes extraordinary income and income from insurance activities.

# 3.3. Risk Management Guidelines

In addition, guidelines for the management of operational risk are proposed by the IFSB. These guidelines operate through process regulation, which requires the Islamic bank to have in place appropriate processes and procedures to identify, measure, monitor, and control operational risk.

# 4. UNIQUE OPERATIONAL RISKS OF ISLAMIC FINANCING/INVESTMENT MODES

In this section, without seeking to be exhaustive, we review some aspects that may give rise to operational risks consequential upon specific financing or investment modes.

# 4.1. Murabahah

Murabahah is one of the most predominantly used contracts in Islamic finance. Apart from credit risk exposures, there are two types of operational risk relating to the structure of a murabahah contract:

(a) The different viewpoints of murabahah permissibility can be a source of operational risk. For example, IT systems employed across jurisdictions may have to be designed to meet the requirements of certain jurisdictions. (b) At the contract signing stage, since the contract requires the Islamic bank to purchase the asset first before selling it to the customer, the bank needs to ensure that the legal implications of the contract properly match the commercial intent of the transactions.

In addition, problems may arise if the *murababah* customer acts as the Islamic bank's agent in the purchase of the asset that is the subject-matter of the contract. For the *murababah* to be valid, title to the asset must first pass to the Islamic bank and not directly to the customer. The documentation, including letters of credit, must be drawn up so as to ensure this.

# 4.2. Salam and Parallel Salam

Salam is a type of forward contract with immediate payment where an Islamic bank assumes the role of the forward purchaser of a commodity. In assuming the role of the purchaser, the bank exposes itself to the following operational risks:

- (a) The bank has to accept the goods that are the subjectmatter of the contract even though they are delivered early, should the specifications be met. The bank may have to incur additional costs such as warehousing, insurance, or even damage (if the goods are perishable in nature) in the event that it cannot sell the goods promptly following delivery.
- (b) Salam is generally associated with the agricultural sector. The buyer must either reject goods of an inferior quality to that specified in the contract, or accept them at the original price. In the latter case, the goods would have to be sold at a discount (unless the customer under a parallel salam agreed to accept the goods at the originally agreed price).
- (c) For salam with parallel salam, the IIFS may face legal risk if the goods cannot be delivered at the specified time (unless the customer under parallel salam agrees to modify the delivery date).

# 4.3. Istisna'a and Parallel Istisna'a

Istisna'a is another type of forward contract, but the role of an Islamic bank as a financial intermediary differs from that in a salam contract.

In this case, the bank contracts to supply a constructed asset (such as a building or a ship) for a customer. In turn, the bank enters into a parallel *istisna'a* with a sub-contractor in order to have the asset constructed. Its reliance on the parallel *istisna'a* counterparty (the sub-contractor) exposes it to various operational risks, which need to be managed by a combination of legal precautions, due diligence in choosing sub-contractors, and technical management by appropriately qualified staff or consultants of the execution of the contract by the sub-contractor. Islamic banks that specialize in *istisna'a* financing may have an engineering department. Risks may include the following:

- (a) The Islamic bank may be unable to deliver the asset on time, owing to time overruns by the sub-contractor under the parallel istisna'a, and may thus face penalties for late completion.
- (b) Cost overruns under the parallel istisna'a contract may, unless agreed with the customer under the istisna'a contract, have to be absorbed partly or wholly by the Islamic bank.
- (c) The sub-contractor may fail to meet quality standards or other requirements of the specification, as agreed with the customer under the istisna'a contract. The IIFS may face legal risk if no agreement is reached with the sub-contractor and the customer either for remedying the defects or for reducing the contract price.
- (d) If the sub-contractor turns out to be unable to complete the work, the bank will need to find a replacement. In certain cases, this may be very difficult and costly.

## 4.4. Ijarah and Ijarah Muntahia Bittamleek

In simple terms, an *ijarah* contract is an operating lease, whereas *ijarah* muntahia bittamleek is a lease-to-purchase (a Shari'ah-compliant alternative to a finance lease). While operational risk exposures during the purchase and holding of the assets may be similar to those in the case of murabahah, other operational risk aspects include the following:

(a) The Islamic bank needs to ensure that the asset will be used in a Shari'ah-compliant manner. Otherwise, it is exposed to non-recognition of the lease income as non-permissible

- and the need to repossess the asset and find a new lessee.
- (b) If the lessee damages the assets in its possession, the Islamic bank may face refusal by the lessee to make the damage good. In such a case, the bank needs to be able to repossess the asset and to take legal action against the lessee to recover damages.
- (c) If the leased asset is severely damaged or destroyed through no fault of the lessee, the Islamic bank as lessor is required to provide an alternative asset, failing which the lessee can terminate the lease without paying rentals for the remaining duration of the contract. Unless the asset is insured, this will result in a loss to the Islamic bank.
- (d) The Islamic bank may be exposed to legal risk in respect of the enforcement of its contractual right to repossess the asset in case of default or misconduct by the lessee. This may be the case particularly when the asset is a house or apartment that is the lessee's home, and the lessee enjoys protection as a tenant.

#### 4.5. Musharakah

Musharakah is a profit- and loss-sharing partnership contract. The Islamic bank may enter into a musharakah with a customer for the purpose of providing a Shari'ah-compliant financing facility to the customer on a profit- and loss-sharing basis. The customer will normally be the managing partner in the venture, but the bank may participate in the management and thus be able to monitor the use of the funds more closely. Typically, a diminishing musharakah will be used for this purpose, and the customer will progressively purchase the bank's share of the venture. Operational risks that may be associated with musharakah investments are as follows:

- (a) The Islamic bank may not perform adequate due diligence in appraising the venture to be financed and the soundness and reliability of the customer. Lack of appropriate technical expertise can be a cause of failure in a new business activity.
- (b) During the musharakah investment period, the bank may not carry out adequate monitoring of the financial performance of the venture, and may fail to receive adequate financial information in order to be able to do so.

## 4.6. Mudarabah

Mudarabah is a profit-sharing and loss-bearing contract under which the financier (rab al mal) entrusts his funds to an entrepreneur (mudarib). Since this type of contract may be used on the assets side of the balance sheet, as well as being used on the funding side for mobilizing investment accounts, the operational risk is first analyzed from the assets-side perspective and then from the funding-side perspective (which is related to fiduciary risk).

#### Asset-side Mudarabah

Contractually, an Islamic bank has no control over the management of the business financed through this mode, the entrepreneur having complete freedom to run the enterprise according to his best judgment. The bank is contractually entitled only to share with the entrepreneur the profits generated by the venture according to the contractually agreed profit-sharing ratio. The entrepreneur as mudarib does not share in any losses which are borne entirely by the rab al mal. The mudarib has an obligation to act in a fiduciary capacity as the manager of the bank's funds, but the situation gives rise to moral hazard especially if there is information asymmetry – that is, the bank does not receive regular and reliable financial reports on the performance of the mudarib. Hence, in addition to due diligence before advancing the funds, the bank needs to take precautions against problems of information asymmetry during the period of investment.

# Funding-side Mudarabah

Profit-sharing (and loss-bearing) investment accounts are a Shari'abcompliant alternative to conventional interest-bearing deposit accounts. Since a mudarabah contract is employed between the Islamic bank and its investment account holders, the IAHs share the profits and bear all losses without having any control or rights of governance over the Islamic bank.

In return, the Islamic bank has fiduciary responsibilities in managing the IAHs' funds. The IAHs typically expect returns on their funds that are comparable to the returns paid by competitors (both other Islamic banks and conventional institutions), but they also expect the Islamic bank to comply with Shari'ah rules and principles at all times. If the Islamic bank is seen to be deficient in its Shari'ah compliance, it is exposed to the risk of IAHs withdrawing their funds and, in serious

cases, of being accused of misconduct and negligence. In the latter case, the funds of the IAHs may be considered to be a liability of the Islamic bank, thus jeopardizing its solvency.

#### 5. CONCLUDING REMARKS

It will be apparent from the above that Islamic banks are exposed to a number of operational risks that are somewhat different from those faced by conventional banks. The relative complexity of a number of their products, as well as their relative novelty in the contemporary financial services market, combined with the fiduciary obligations of an Islamic bank when it acts as a *mudarib*, imply that for Islamic banks operational risk is a very important consideration.

For these reasons, the IFSB has taken the position that, while IAHs may be considered (in the absence of misconduct and negligence by the Islamic bank) to bear the credit and market risks of assets in which their funds have been invested by the bank, the latter must be considered as being exposed to the operational risk arising from its management of those funds. Hence, the IFSB Capital Adequacy Standard requires Islamic banks to take account of this operational risk exposure in calculating their regulatory capital requirement.

# Law and Islamic Finance: An Interactive Analysis

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#### 1. INTRODUCTION AND OVERVIEW

ne of the most prominent features of the "modern era" (approximately 1390 H.E., or 1971 C.E.) in respect of the development of the Islamic economy is the interactive influence of law and Islamic finance. Islamic finance is fertilizing the development of law, particularly in its jurisprudential sense. And law, in both its jurisprudential and practical applications, is stimulating and shaping the growth of Islamic finance. This is the theme of this chapter. There is no pretense at comprehensive coverage of these interactive influences; the approach is to discuss only a handful of examples taken from both Islamic Shari'ah and secular law.

We begin with an historical analysis of how Islamic finance has influenced the development of Islamic jurisprudence. From little more than a concept in the first decades after most Muslim countries regained their independence following World War II, modern Islamic finance took the form of Islamic banks and investment houses in the 1970s and 1980s, and a growing body of scholarship was generated by the practical needs of those institutions as they began to proliferate, particularly as they accumulated more deposits and the demands for product diversity grew more insistent.

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No legal system can remain viable without a subject, without an object, for its application. In recent centuries, and until the 1970s and 1980s, throughout much of the Muslim world, the only significant finance available to Muslims was what Western commercial banks had to offer: primarily interest-based products. Without active commerce, the Shari'ah rules for transacting would become no more than a subject of academic concern, like-a dead language. Without renewal, without constant attention on the part of qualified jurists to changing circumstances and realities, those rules, like any other system, would atrophy and eventually lose relevance. Islamic banking and finance in the 1970s and 1980s provided the living subject to which Islamic jurists turned their attention.

Given the inherent depth and breadth of classical Islamic commercial law, modern jurists found a veritable ocean of practical and theoretical jurisprudence upon which to draw while confronting the challenges of the modern marketplace. The first few decades of the modern era may be characterized as a period of revival. The most recent decade has been a period of significant innovation. Using the nominate contracts for trade and exchange as their building blocks, modern Muslim jurists have provided Shari'ah-compliant solutions to an ever-expanding spectrum of needs.

Thus, Section 2 of this chapter moves from a consideration of the foundations of Islamic commercial law to the factors that have influenced the evolution of that law in modern times. The rise of modern Islamic banking is examined as a factor that has moved Islamic finance through a period of "revival and recovery" to a period of "transformation and adaptation." The period of revival and recovery was characterized by the presence of relatively few Islamic banks, relatively few Shari'ah scholars with knowledge and practical experience in financial and commercial transactions, a focus primarily on the deposit side of Islamic banking, and discourse on Islamic finance primarily in the Arabic language. The current period of transformation and adaptation is characterized by a significant number of Islamic and conventional multinational banks and financial institutions as participants, participation by Shari'ah-compliant and conventional asset managers, the development of significant practical experience by Muslim jurisprudents in an expanding range of financial and commercial transactions of increasing complexity, a growing discourse on Islamic finance in the English language, a movement toward consensus among Shari'ah scholars (ijma'), the acceptance and implementation of the concept that the nominate contracts may be thought of as building

blocks that may be constituted and constructed creatively for the achievement of all manner of objectives, and a transactional base that entails conformity with both the *Shari'ah* and at least one body of secular law. Other factors of particular importance include increasing internationalization and globalization and the rapid movement to greater breadth and sophistication of Islamic financial products.

Later sections of this chapter move the focus from a general historical review of jurisprudential trends to a detailed analysis of how the practical application of law influences the growth and development of Islamic finance and the Islamic economy. A primary function of law and legal systems is the provision of transparency certainty and predictability to market participants and the society at large. Contracts constitute a type of private law for individual transactions and groups of transactions.

Thus, the enforceability of contracts is an area of immediate relevance, and one that must be clearly understood. Modern Shari'ahcompliant transactions involve both the Shari'ah and secular law. with the contribution of each varying from jurisdiction to jurisdiction. Initial inquiry must focus on the issue of how to ensure that the provisions of a commercial or financing transaction that is structured in accordance with, and intended to be compliant with, the principles and precepts of the Shari'ah will be enforced by the courts and other enforcement bodies of different jurisdictions, and will be enforced in accordance with the terms of the contract as agreed by the parties to that contract. Consideration must be given to enforcement issues in both (a) those jurisdictions that incorporate the Shari'ah in their substantive law and thus will enforce contractual arrangements in accordance with the Shari'ah because the governing law will itself include the Shari'ah ("Shari'ah-incorporated jurisdictions"), and (b) those jurisdictions that take no cognizance of the Shari'ah and thus will not enforce it as a matter of governing law but may enforce it as a matter of enforcement of a contract under the governing law of that jurisdiction ("purely secular jurisdictions").

Enforceability is a function of the law of the enforcing jurisdiction. Choice of law issues come to the fore in every jurisdiction given that Shari'ab-compliant transactions, and documents that are themselves compliant with the Shari'ah, must be enforced in purely secular jurisdictions. A recent English law case, Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco Pharmaceuticals Ltd. and Others, provides a framework for discussion and analysis of choice of law issues, particularly the choice of the Shari'ah as governing law. This

case addressed issues of enforcement of the Shari'ah in a purely secular jurisdiction (England) where the contracts at issue specified the use of English law as the governing law, subject to the Shari'ah.

Thereafter, enforceability is considered in another, distinct analytical framework: the legal opinion on enforceability of transactional documents that is required in essentially every financing transaction. The nature and essential elements of these legal opinions are considered both generally and with respect to Shari'ah-compliant transactions. The focus is on the specific legal opinion that the relevant "agreements are valid and binding obligations, enforceable in accordance with their terms."

The chapter closes with consideration of an example of an area in which law has a profound impact on the future of Islamic finance, both as to the structure of individual transactions and as to the shape of capital markets, particularly secondary markets, and thus the configuration of the entire Islamic finance industry and the Islamic economy. The example that is considered relates to sukuk issuances, current and future, and the nature of Islamic capital markets. Sukuk issuances access, and help to establish and build, the capital markets. Securitizations, however, have far broader implications. They allow for diversification and pooling of risks. They allow asset originators to manage their balance sheets and their capital structure and increase their productive capacity. And they have a special role in creating and sustaining capital markets – in particular, secondary markets.

Current sukuk issuances are primarily Islamic bonds, most frequently bonds that are based upon sovereign credits. As of this writing, true securitizations that are based solely upon the credit of the securitized assets are rare. If the benefits of securitization are to be obtained for Islamic finance and the Islamic economy, there will have to be continuous issuances of asset-based securitization sukuk by the private sector. That cannot be achieved without having those issuances rated by the major international rating agencies. Obtaining those ratings, in turn, is dependent, among other things, upon obtaining the requisite legal opinions from prominent law firms engaged in these issuance transactions. These legal opinions must address a broad range of critical issues focusing on sale, collateral security, and bankruptcy issues, among others. Thus there is discussion of true sales of assets, non-consolidation of assets, bankruptcy remoteness covenants, collateral security considerations, enforceability of contracts issues, choice of law doctrines, and issues pertaining to the enforcement of judgments and foreign awards. The ability of law firms to opine on these essential matters in many jurisdictions within the Islamic economic sphere (see below) is presently non-existent or severely limited, with the consequence that capital market and secondary market growth is severely constrained. It will be necessary to address fundamental legal reforms and clarifications in the secular legal realm, as well as greater clarity of applicable Shari'ah principles and precepts, if these markets are to be fully developed.

For the purposes of this chapter, (i) there is reference to the jurisdictions and economies, without distinction as to cultural, political, and economic factors, of the Middle East, North Africa, and South and Southeast Asia that have predominantly Muslim populations as the Islamic economic sphere, and (ii) the jurisdictions and economies, similarly without distinction, of the remainder of the world in which banking and finance is conducted primarily using an interest-based model are referred to as the Western economic sphere, as well as to Shari'ah-incorporated jurisdictions and purely secular jurisdictions.

# 2. ISLAMIC JURISPRUDENCE IN MODERN TIMES

#### 2.1. Foundations of Islamic Commercial Law

"The Lawful is self evident and the Unlawful is self evident," the Prophet of Islam (upon him be peace) said to his followers some 14 centuries ago. Then he added. "Yet between the two are matters that may give rise to confusion; not well understood by many people."

In making this statement, the Prophet laid the foundations for the legal system of Islam, generally known as the Shari'ah. Since that time, generations of jurists throughout the Muslim world have applied themselves to the explication and interpretation of Shari'ah rules. The role of the jurist in Islam has been to focus attention on what is less than self-evident, the gray areas between what is clearly lawful or unlawful, the areas of potential confusion.

The Shari'ah, literally "the way," is the Muslim's "way of life," the rules which govern how Muslims conduct every aspect of their lives. When Islam is understood to mean "commitment," that means that a life lived in accordance with Islamic norms is a life of commitment; and the Shari'ah may be said to be the divine delineation of the life of commitment. Then, if one is truly to live that life, one must come to terms with how that life is actually delineated by the Divine. It is

precisely that "coming to terms" that is known in classical Muslim scholarship as "figh," or Islamic jurisprudence.

The Shari'ah is also concerned with social justice. In the marketplace, the role of the Shari'ah is prominent because the business of earning a living concerns everyone, as individuals, as groups within society, and as citizens of nations and the world. The logic of the relevant Islamic teachings is that everyone will benefit when people earn their living in a wholesome and lawful manner; and social stability is supported by commercial society. Thus, at the core of Islamic finance are religious precepts governing what is good and permitted, or lawful, and what is harmful and forbidden, or unlawful. It is the responsibility of the jurist to help distinguish the one from the other. As markets grow in sophistication, and transactions become increasingly complex, that responsibility becomes more and more challenging.

It may also be helpful to think of the Shari'ah as a "shared endeavor," It is shared, in the first place, between God and humankind. God is the Lawgiver, and humans have the responsibility to receive, understand, and observe the Divine law. Humans are also responsible for preserving it, and for endowing it with renewed relevance in changing times and in a variety of settings. So, in this sense, Shari'ah is an endeavor shared between jurists and the texts of revelation, through their understanding and interpretation of the meanings of these texts. The same endeavor is then shared by jurists among themselves, whether through applying themselves collectively to solve a particular problem or through their reference to the works of distinguished jurists, both past and present. In the world of modern finance, it is shared with authorities and experts from the business world, with lawyers from numerous practice areas (often several for a single project), with regulators and their authorities, and, finally, with the investing, transacting, and consuming public.

#### 2.2. Islamic Commercial Law in Modern Times

In recent centuries, over much of the Muslim world, the Shari'ah of Islam was marginalized during an interregnum when Islam's social and economic institutions were displaced by Western models. For example, in the Indian subcontinent the British imported their own legal system; leaving little more than what amounted to "marrying and burying" as the legitimate concerns of what they termed "Muhammadan Law." Under those circumstances it is hardly surprising that

a century or two later, when Muslims finally gained independence, their own Islamic legal institutions were woefully unprepared to deal with 20th-century realities. The same was true of Islamic political, educational, and economic institutions. Thus, during that interregnum, it is not surprising that Islamic jurisprudence, with no place to apply its dynamic of *ijtihad*, was relegated to a long confinement in exclusively academic settings. In order for it to break out of the confines of academia, Islamic jurisprudence required a real subject, a practical and living application, and practitioners who were not only conversant with the classical discipline but were also cognizant and appreciative of the changes the world had undergone in the intervening centuries.

Oil wealth may have provided the real impetus for the revival of the Islamic jurisprudence of commerce and finance. In the decades of the 1950s and 1960s, at a time when newly independent Muslim states were attempting to come to terms with their cultural and religious identities, a handful of Muslim thinkers began speculating on the theoretical foundations of an Islamic economic system, often as an afterthought to their musings about an ideal Islamic state. The state banks of a few Muslim countries held conferences to discuss the subject, a few scholars published papers in journals, and, in general, the interest in the subject was academic. But with the wealth from oil, the petrodollars of the 1970s, a number of banks and investment houses were established with the clear mandate to operate in accordance with Shari'ah.<sup>4</sup> This is what marks the beginnings of modern Islamic finance.

At the time, to be candid, there was little that was clear in regard to banking operations conducted in accordance with the Shari'ah; in fact, Shari'ah and banking seemed particularly unsuited to any sort of collaboration. The Qur'anic prohibition of riba, equating in a general sense to interest and predicated on the understanding that money is a measure of value and possesses no intrinsic value of its own, precluded any sort of dealing with banks and banking. Indeed, throughout the Muslim world, the common understanding was that there was nothing lawful about banks. Even employment in banks was shunned in religious circles.

When the new Islamic banks were established, the first matters for consideration were deposits and savings accounts. How might these operate if no interest was to be paid? And, on the other side of the balance sheet, how would the Islamic banks invest and earn returns, if no interest was to be earned ... if interest was not even a part of earnings? How, finally, could the Islamic banks become profitable?<sup>5</sup>

# 2.3. The Jurisprudence of Revival and Recovery

It was then that the new Islamic banks called upon scholars of the Shari'ah for answers. In those early days, there were few scholars with knowledge of finance and banking. The handful of scholars that had published on related subjects were without practical experience, having had no exposure whatsoever to modern banks and financial markets. In many cases, banks retained scholars based solely on their reputations as authors and authorities on Islamic subjects in general; not as experts or authors of works on finance or related subjects.6 Thus, as in any fledgling industry, there was a period of adjustment and learning. The process was a rewarding one, however, and though there were difficulties, a good deal of progress was achieved. It is possible, and not unfair, to characterize the jurisprudence of this early period, perhaps the first two decades, as the jurisprudence of "revival and recovery." During this period, scholars looked to the past and reestablished meaningful connections between the Shari'ah and the practical world of modern commerce and trade. In this undertaking they turned to the vast body of legal literature created by earlier generations, to the rules of commerce in the legal handbooks and glosses, and to the digests of case law or fatwa literature. In many cases, the sources they referenced were of their own particular legal schools of thought, madhahib, though there appears to have been, early in this process, a general understanding that consideration would have to be given to the opinions and methodologies of at least four major legal schools.

At this time, too, perhaps owing to the extraordinary demands placed upon individual scholars hired as advisors, and partially in order to bring to bear a wider range of legal opinion representing each of the four major schools of classical legal thought, as well as regional and cultural trends, Islamic banks began to establish Shari'ah supervisory boards, often with as many as six or eight members. A collective and inclusive approach such as this was not new to Islamic law, ever a shared endeavor. In fact, the classical schools of legal thought themselves grew out of academics. The Hanafi school, for example (named for an individual, Abu Hanifah), was developed over several decades during which regular assemblies in the city of Kufah were attended by a core group of about 40 scholars from a

variety of disciplines. Much the same process took place in Madinah, where Imam Malik presided, in Baghdad and then Cairo where Imam Shafii led similar groups of the learned, and again in Baghdad, over a half-century later, where Imam Ahmad ibn Hanbal became the focal point of still another such academy.<sup>7</sup>

Throughout the formative period of the 1970s and 1980s, Shari'ah deliberations on issues related to modern banking were carried out collectively by formally constituted Shari'ah boards. Papers were written and discussed, both internally among Shari'ah supervisory boards and externally at conferences and seminars. The most important factor in everything that took place at the time, however, was that the jurisprudence had a real subject with which to deal and interact: the growing practice of Islamic finance. The deliberations of Shari'ah boards were more than speculation, or theoretical musings, or academic exercises. Real issues were involved and, perhaps more importantly, real people's money. For, from the day the Islamic banks first opened for business, they have attracted deposits from average Muslim consumers, in addition to their high-net-worth and institutional clientele. For Muslims, the Islamic banks are a godsend. allowing them the opportunity to invest and transact in ways that leave their consciences clear. This has come as a great relief to Muslims the world over; and the numbers speak for themselves.

Another factor was at work at the time the Islamic banks opened their doors for business. Shari'ah scholarship on financial matters had found a patron. Prior to that time, scholars engaged in the jurisprudence of finance did so on their own and generally as a purely academic pursuit. Orientalists such as Schacht, Udovitch, and Goitein made significant contributions to the knowledge of Islamic commercial law (in particular, with respect to the classical nominate contracts) in the two decades after World War II, and their work motivated and guided a handful of Muslim university students and professors who followed. But Islamic finance now constituted a practical industry, and a growing industry cannot progress if guidance is the result of the random output of a scattered and unassociated group of scholars. The demands of Islamic banks were specific, and time-sensitive, and could not be allowed to depend on personal schedules and agendas of academics. Through the establishment of formal Shari'ah supervisory boards, whose members were compensated for their efforts, the Islamic banks brought scholarship to bear directly upon the issues of greatest concern to them and, by doing so, enabled a new generation

of jurists to acquire expertise on the subjects of modern banking and finance through research and scholarly exchange.

Then, as a collectivity with incentives, the Shari'ah boards of the first Islamic banks set about developing ways and means to facilitate the unique and novel operations of those banks. Their first concern was, and remains, the issue of compliance, Shari'ah compliance. However, without a process in place for their deliberations, their beginnings were tentative at best as the problems before them were complex and challenging.

# 2.4. Adjusting to Modern Trade and Commerce

To begin with, there was the fact that interest-based Western finance had advanced considerably during the interregnum, while Islamic jurisprudence had remained marginalized and inert. There were no ready solutions to be had from the classical legal literature because, for the most part, the classics never dealt with the sorts of issues facing the modern Islamic banks. Advances in technology facilitated commercial activity such as cross-border investing and correspondent banking on unprecedented scales, while regulatory environments and tax laws made it far more complex. The volume of commerce and the rapidity with which it may be accomplished were to have profound effects on legal systems worldwide. The same was true of modern phenomena such as the Industrial Revolution, the rise of consumerism, the proliferation of debt financing and unsecured lending, and the abandonment of the gold standard. By the time the modern Islamic banks commenced business in the 1970s, the financial community worldwide had already passed through several stages of legislation, and regulatory reform focused on, ultimately, the protection of the consumer/investor. Modern reforms in the laws of the United States (and especially in regards to finance, banking, securities issuances, investment activities, and business), for example, included matters restricting the nearly unlimited contracting power of the sort envisioned in the classical law of contract known as the "duties of the common calling." Likewise, modern law had introduced relational torts and expanded understanding of bad faith breach.8 The complexities of today's financial engineering, as exemplified in overthe-counter (OTC) derivatives, stress existing securities laws. Thus, if modern conventional finance is moving more quickly than the law, it should come as no surprise that modern Muslim jurists discovered themselves confronted by a very steep learning curve when attempting to make sense of the new commercial and financial practices proposed to them by the management of the new Islamic banks in those initial decades.

In addition, there was no code, not even an outdated one, toward which modern Shari'ah boards might turn for guidance. The one exception was the Ottoman code known as al-Majallah or the Majelle:9 but it was limited to only one school of jurisprudence. It is the nature of Islamic jurisprudence itself to insist on the freedom of qualified jurists to formulate and hold their own opinions. In fact, the inner dynamic for renewal known as ijtihad ensures the relevance of Islamic law to changing circumstances by empowering jurists constantly to revisit points of law and to improve upon them as necessary. However, while there was no such uniform code, there was also no requirement of the immutability of previous determinations. Indeed, Islamic law resembles in many ways the British and American legal systems based on common law, a type of judicial law based upon the interpretations of judges as individual jurists constrained by the principle of stare decisis, or binding precedent. 10 Thus, while Shari'ah board members found themselves in the midst of new and uncharted legal territory, they at least had the freedom to think for themselves. This is a significant point, and one that has been ignored by many academics and others. For, despite all else, the fact remains that scholarship on the Shari'ah-however isolated, marginalized-and academic-continued to thrive in Muslim lands. Thus, when the time came to apply serious scholarship to Islamic banking and finance, there was no shortage of scholars with the ability and the training, albeit lacking practical financial experience, to take up the challenge.

In this context, the early Shari'ah boards sought help in the classical system of nominate contracts ('uqud musammat). These are contracts that are widely known by specific names, such as murabahah, mudarabah, wakalah, and ijarah. Debates on the provenance of these contracts aside, it is well known that trade and commerce were highly developed in the Arabian peninsula before the advent of Islam. Then, even if the nominate contracts were based on earlier models, their real value was that they were widely known and accepted. By insisting that Muslims transact by means of a specific set of well-defined contracts, the Shari'ah ensures that all parties have every opportunity to understand their prospective transactions. The classical Islamic system of mu'amalat (transactions) is so highly articulated for precisely this reason. While the scriptural foundations

of that system may be abbreviated, owing to their delineation of principles rather than specifics, the dynamic of *ijtahad*<sup>12</sup> inherent to *fiqh* has ensured that Muslim jurists, especially *Shari'ah* boards, continue to comment and build upon the theoretical constructs.

# 2.5. The Significance of Contracts

A further important aspect to the nominate contracts, as with other contracts in sophisticated legal systems, is that they constitute a means for risk allocation and management. In order to understand this point, think of a contract as a device for stabilizing the uncertainty of the future, risk, by connecting that future to the stability of a known past.

... the past and the future are to the economy what warp and woof are to a fabric. We make no decision without reference to a past that we inderstand with some degree of certainty and to a future about which we have no certain knowledge. Contracts and liquidity protect us from unwelcome consequences....12

Relatively speaking, it may be asserted that the contracts defined by Islamic law represent solid ground. Indeed, it may also be asserted that the reason the institution of banking did not develop in Muslim lands is that it was simply not needed. The nominate contracts prescribed for trade and business by the Shari'ah were recognized and, most importantly, upheld by Islamic courts from Spain to China and the Philippines. Thus, within the framework of the Islamic legal system, held together as it were by a set of prescribed contracts, an Islamic legal system of finance and economics flourished in the Islamic East for centuries. To quote from the work of Dr. Nelly Hanna:

One aspect of trade in the Middle East that has often been emphasized is that there was no system for advancing funds to merchants – that is, there was no equivalent to the European banking system on which European merchants were heavily dependent – and the lack of such a system supposedly handicapped merchants of the Middle East . . but the functions of this institution were in part fulfilled through the legal system, which provided a legal framework for the advancing of funds. <sup>14</sup>

Thus, the contracts upon which transacting in Islam is based function both to stabilize and to promote. By their very nature,

these contracts act as a hedge against uncertainty. In addition, the circumstance of their standardization contributed significantly to the comfort level of investors and entrepreneurs, and allowed Muslims to finance huge projects and international trade without the need for intermediaries such as banks.<sup>15</sup>

The variety of purposes to which these contracts were put to use is worthy of special attention especially in view of the fact that so much has been written about the rigidity of Islamic law and its inability to adapt to various kinds of situations. The experience of seventeenth century merchants who carried out a significant portion of their trade within the framework of the judiciary system gives an entirely different perspective on this matter. Rather than a rigid set of imposed laws that were supposed to have suffocated the business, the commercial documents show a legal system that was adaptable to various kinds of situations. 17

## 2.6. The Nominate Contracts

Despite at least partial disuse of the classical system of Islamic finance during the interregnum, the foundations of that system, the nominate contracts upon which it was predicated, remained well defined. Thus, it was to these that the Shari'ah boards of the new Islamic banks turned for guidance. The corpus of classical legal literature on the subject of transactions, and particularly the nominate contracts, is immense. The published literature in Arabic alone runs into several thousands of volumes, and educated estimates gauge the size of the unpublished works preserved as manuscripts in libraries around the world as at least three to four times the size of the published works. It is impossible to know how much has been lost over the centuries. In any case, the important thing is that Shari'ah boards were able to reference hundreds of titles, and many thousands of fatawa. from earlier centuries. This availability facilitated the jurisprudence of revival and recovery alluded to earlier as characterizing the early period of Islamic banking and finance during the decades of the 1970s and 1980s.

The most important factor in the transition from the jurisprudence of recovery and revival to a more proactive and participatory jurisprudence of transformation and innovation was the reconfiguration of the nominate contracts. This process began with the concept that the nominate contracts may be used as building blocks for the constructive and creative achievement of all manner of objectives. 18 From the inception of Islamic banking in the 1970s it was apparent that a certain degree of adaptation was required for the successful application of the nominate contracts in modern finance. For example, in order to make the murabahah contract effective in the business of inventory or short-term trade financing, it was necessary to depart somewhat from the classical model by combining a promise to buy on the part of a client with the actual purchase by the bank of goods from third-party suppliers. 19 Then, in addition to the actual murabahah contract, a further transaction is appended; the promise to purchase that is made by the client or prospective buyer.20 This arrangement, however innocent in appearance, actually brought up a host of issues for the early Shari'ah boards. Nonetheless, as the needs of modern trade were such that a Shari'ah-compliant alternative to trade financing by means of conventional, interest-based financing was required, the classical murabahah was transformed into the modern murabahah li'l-amir bi'sh-shira, murabahah with an order to purchase that has now become commonplace to Islamic banking. This is only one of scores, if not hundreds, of such examples of how simple nominates have been linked and reconfigured for the attainment of new objectives.21

Another result of the extended hiatus endured by the Islamic jurisprudence of finance is that it lost contact with custom and usage. In the classical system, custom ('urf) played an important role. The legal maxim that "all transactions are to be considered lawful as long as they include nothing that is prohibited" went hand-in-hand with custom and mercantile practice in clearing the way for innovation in trade and commerce. However, when the Shari'ah boards of the modern Islamic banks began their work in the 1970s, there was no significant Shari'ah-compliant trade taking place, and thus no customary practice in regard to it. Second, members of the Shari'ah boards, with no more than minimal exposure to modern finance, had little understanding of what was customary among modern financial practitioners. Thus, this all-important factor, too, was missing from the equation.

# 2.7. Academic and Linguistic Factors

The early work of the Shari'ah boards was tentative and, in keeping with the universal bias among jurists toward prudence, clearly conservative. Moreover, as the majority of the Shari'ah boards' membership

was drawn from the ranks of academics, their work tended toward the academic. Under the circumstances, this was for the best. Seminars and conferences were organized, and papers were presented and debated. Professors directed a handful of graduate students to write on subjects related to *Shari'ah* as it pertained to banking, finance, and commerce. Indeed, in the late 1970s, a team of primarily Egyptian academics began work on the production of a five-volume encyclopedia of Islamic banking that served as an important general introduction for the next decade.<sup>22</sup> The work undertaken at this time, like the scholarly exchanges, was almost exclusively conducted in the Arabic language. The language factor was, and remains, significant, with consequences that are discussed later in this section.

During this initial period of recovery and revival, it is notable that scholars began to reacquaint themselves with the workings of the nominate contracts. The significance of this focus was two-fold. First, the nominate contracts, even in their classical forms (and in the forms they had attained before their development was interrupted), provided immediate solutions to several of the banks' most pressing needs. Second, as scholars and bankers became more familiar with these contracts (or specified ways of transacting), they began coming to terms with how these might be applied in novel ways. Indeed, their facility with the nominate contracts was the key to the next stage of development in modern Islamic finance. Of course, there were other factors. But this single factor (facility with the nominate contracts), through regular exposure to the day-to-day business of the Islamic banks, is what provided the tools for the breakthroughs that would occur in the decade of the 1990s, and that continue until today.

Before discussing this breakthrough, consider for a moment the issue of language and what it has meant to Islamic finance. There is no denying the merits of the Arabic language or the advantages it brings to those who know it. Even so, from the day the first Islamic banks opened their doors for business, much of that business was conducted in the English language. After all, as the language of international finance, trade, and commerce, it was only natural that English be used in the Islamic banks. However, while management conversed with correspondent banks, counterparties, trading partners, regulators, and legal counsel in English, Shari'ah supervision in the initial period was conducted almost exclusively in Arabic. In several of the early fatawa, it is clear that the board had given its opinion on the basis of representations made by management; the Shari'ah board members

themselves did not read the documentation, but relied upon summaries presented to them in translation. The reason for this situation was that Shari'ah board members, with a very few exceptions, had no English language capability. To a degree, this remains a problem even today.<sup>23</sup> The important thing is that, in some cases at least, Shari'ah boards were simply unable to understand, and therefore unable to comment upon, the details of the subject transactions.

On the other hand, the business and legal professionals who did not speak Arabic had perforce to go to secondary sources to learn about Islamic finance and, in particular, to the jurisprudence of Islamic finance, a particularly inhibiting circumstance. For these professionals, even for those working in the Islamic banks themselves, such as non-Arabic-speaking expatriates, the lack of access to authoritative opinions presented difficulties, with the result that initiatives toward innovation and improvement were slow to come. Product development and process improvement, under such circumstances, became onerous and cumbersome tasks. Without direct access to the Shari'ah boards, legal counsel needed to rely on management to translate and summarize their work. Feedback from the Shari'ah boards under those circumstances was little better than hit or miss. None of this was conducive to progress. Instead, the Islamic banks appeared to most Western professionals, even to Western academics, to work behind a veil of mystery. If the fundamental principles were understood, the details were not. In fact, until books on the subject began to appear in English and other languages, even the fundamentals were incomprehensible to all but the most dedicated and determined individuals.

# 2.8. A New Stage in the Jurisprudence of Islamic Finance

Near the end of the decade of the 1980s, however, these situations had begun to change. By this time, Islamic banking and finance had grown far beyond the expectations of even the most fervent among its early supporters. In fact, Islamic finance became recognized as a growth industry; and a number of multinational banks and asset management companies were taking an interest in its development. Within the industry itself, significant developments were afoot. One of the main reasons for these developments was the progress made by Muslim jurisprudents in understanding the business of commerce and finance and in applying Shari'ah principles and precepts to it. Another reason was the facility developed by

Shari'ah boards with the nominate contracts, such that they began to feel comfortable with novel configurations. Other reasons for development were the growing discourse on Islamic finance in the English language. Finally, the academic discourse on the subject had achieved a critical mass and many issues were moving toward consensus, the all-important ijma' or general acceptance of the juristic community considered a binding adjudicator (or indicator, dalil) in Islamic law.

Undoubtedly, big players with their human and capital resources did much to spur the development of Islamic finance. Their influence on the jurisprudence of Islamic finance, however, has been more subtle. Before discussing the innovations made by scholars with respect to the nominate contracts, it will be well to begin with a discussion of how the multinationals and global asset managers helped the jurisprudence of Islamic finance to move into a significant new stage of creativity. Certainly a part of this involved the growing facility of Shari'ah scholars with English. To a degree, these two factors went hand in hand. Clearly it is true in any profession that it is one thing to acquire experience, and quite another to have exposure to the top echelons of that profession. Shari'ah scholars began working closely with Wall Street insiders, with some of the most knowledgeable and talented individuals in the business, and it was then that the exchange of ideas began in earnest. In some cases, a single member of a Shari'ah board would take part in such exchanges and report back, formally or figuratively, to his peers on the board, Exchanges of this nature provided Shari'ah scholars with valuable, and often key, insights into business procedures and practices that might otherwise have remained obscure and therefore suspect. Nor was this process of exchange a one-way street. On the contrary, as their own understanding of modern business concepts and practices increased, Shari'ah scholars were emboldened to make comments of their own, often pointing out parallels that exist between fundamental Shari'ah concepts of transacting and modern commercial law; and then moving on to extrapolate shared concepts and to consider their possible applications in modern situations. Through such exchanges many scholars acquired an insider's grasp of the context of modern commerce. Clearly, such exposure added perspective and depth to the deliberations of Shari'ah boards on the jurisprudence of modern Islamic finance. While it may be difficult, if not impossible, to quantify or point directly to such intangibles, it is equally as difficult to deny their influence.

# 2.9. The Jurisprudence of Transformation and Innovation

As noted in Section 2.6, the most important factor in the transition from the jurisprudence of recovery and revival to a more proactive and participatory jurisprudence of innovation and transformation was the reconfiguration of the nominate contracts or, perhaps more exactly, the concept that the nominate contracts may be thought of as building blocks that may be constituted and constructed creatively for the achievement of all manner of objectives. Section 2.6 discusses the transformation of the classical murabahah into the modern murabahah li'l-amir bi'sh-shira, murabahah as an example of the application of this concept.

Following the success of this experience, Shari'ah boards went on to engineer and approve a host of hybrid nominates, using a single nominate such as murabahah in different configurations (such as parallel murabahah, reverse murabahah, back-to-back murabahah, and reverse parallel murabahah contracts), or using a plurality of nominate contracts in combination with one another. In this manner, the nominate mainstays of classical Islamic commercial law, musharakah, ijarah, salam, istisna'a, mudarabah, and others, were transformed and adapted in a variety of ways to modern needs and circumstances. A case in point is the adaptation of these contracts to bring about interest-free alternatives to conventional mortgages for the financing of homes;24 in other cases, these became key elements in investment funds, project finance, and, most recently, in sukuk.25 In fact, the contracts for the financing of homes by one U.S. company have recently been securitized and converted to sukuk issued by Freddie Mac with all the qualities of U.S. government-secured paper. It would be interesting, as an academic case study, to follow and analyze the transformation and adaptation of all the different nominates applied in that one instrument, as it includes the creative application of many disparate elements.

As discussed earlier, one of the factors in the development of a modern Islamic financial and commercial jurisprudence has been the ability of scholars to communicate their ideas among themselves and, through debate and discussion with colleagues and peers and, to an extent, through demonstrating by means of actual business applications, to bring about general agreement and approval throughout the scholarly community. The importance of this point, of this process itself, cannot be over-emphasized because the concept of ijma' as a legal indicator, dalil, carries very nearly the same authority as the revelational sources<sup>26</sup> themselves. Whatever questions, reservations,

or doubts the critics of modern scholarship may have on this subject, the fact that Shari'ah boards have been able to achieve consensus on so many key issues suffices to establish the legitimacy of modern Islamic finance and, more importantly from a practical perspective, sets the stage for the establishment of industry standards which may, in turn, provide the impetus for real industry growth. Through the efforts of the various academies, especially those with international and regional representation, such as the OIC Figh Academy, and through the regular exchanges by scholars at seminars and conferences, particularly those like the annual Albaraka seminars in Jeddah, a serious process has been ongoing since the 1970s.

Finally, with the establishment of the Auditing and Accounting Organization for Islamic Financial Institutions (AAOIFI) in the early 1990s, the process for bringing scholarly attention to focus on particular issues was streamlined, with the result that consensus could be brought about through an institution, and then regular standards for a wide spectrum of Shari'ah-related issues could be approved and implemented. The transparency, thoroughness, and inclusiveness of the process employed by the AAOIFI have contributed in so many different ways to the growth of this industry that it would require a separate paper to do justice to each. Finally, the newly established Islamic Financial Services Board (IFSB) ensures that the efforts of Shari'ah scholars and financial and legal practitioners for the achievement of consensus and standardization will find a place in legal and regulatory systems worldwide.

In the brief span of a few decades, Shari'ah scholars across the world have worked together and with others to bring about the revival of one of Islam's most important institutions, its finance. In the process, Islamic jurisprudence has undergone significant development. Moreover, the revival of Islamic commercial energies has led to an expansion of cooperation and mutually beneficial exchanges between Muslims and the other peoples of the world. This can only lead to a better and brighter future for all.

#### 3. ENFORCEABILITY OF THE SHARI'AH

# 3.1. Trends in Islamic Finance and the Focus on Enforcing Islamic Shari'ah

As noted in the first sections of this chapter, Islamic finance in the modern era has passed through a period of "revival and recovery" to a period of "transformation and adaptation." The current period of transformation and adaptation is characterized by a significant number of Islamic and conventional multinational banks and financial institutions as participants, participation by Shari'ah-compliant and conventional asset managers, the development of significant practical experience by Muslim jurisprudents in an expanding range of financial and commercial transactions of increasing complexity, a growing discourse on Islamic finance in the English language, a movement toward consensus among Shari'ah scholars (ijma'), the acceptance and implementation of the concept that the nominate contracts may be thought of as building blocks that may be constituted and constructed creatively for the achievement of all manner of objectives, and a transactional base that entails conformity with both the Shari'ah and at least one body of secular law.

Three trends during the period of transformation and adaptation are particularly notable: (a) "internationalization" and "globalization"; (b) diversification of Shari'ah-compliant financial products and structures; and (c) increasing sophistication of those products and structures. Each of these developments has the effect of focusing attention more immediately and more precisely on the issue of whether the principles and precepts of the Shari'ah will be legally enforced in any given circumstance, with respect of any given structure, product or transaction, and in any given jurisdiction. Of course, this is occasioned by the focus of all concerned with Shari'ah-compliant transactions, be they seeking such compliance or indifferent to such compliance, with the degree of certainty, predictability, and transparency of the Shari'ah-compliant structure, product, or transaction and with the functioning of the relevant legal regimes as risk allocators. Much of the history of commercial law in the United States, England, France, and many other countries that have been successful in promoting commercial interests (and, essentially "exporting" their law as a governing law of commercial and financial transactions) relates to the certainty, predictability, and transparency of the legal system and legal determinations in respect of commercial and financial matters, as well as the principles of risk allocation, fairness, and justice.

The transactional context that focuses on the enforceability of the Shari'ah is best examined by considering some illustrative examples of modern transactions. One type of transaction is a Shari'ah-compliant transaction in the United States involving the development of a real estate project by a non-Muslim U.S. developer with financing provided by a non-Islamic U.S. bank.<sup>27</sup> A Muslim investor from the

Middle East or Southeast Asia desires to invest in the construction and development of this project in compliance with the Shari'ah, and that investor's Shari'ah supervisory board will review and pass upon the structure and documentation of the transaction. The investment in, and financing of, the project must comply with the secular law of the relevant state of the United States as well as applicable federal laws of the United States. The developer and the financing bank agree to participate in a Shari'ah-compliant transaction structured as an istisna'a-ijarah, although neither has any informed knowledge of what these structures entail and despite the fact that documents such as these are unknown, in this type of transaction, in the United States.

Another example is the issuance of sukuk, a Shari'ah-compliant pass-through securitization of assets located in a Shari'ahincorporated jurisdiction. The asset originator is located in that same jurisdiction. Assume that the sukuk issuer is a special purpose vehicle located in a purely secular jurisdiction that allows for the choice of applicable law for financial transactions. And assume that the sukuk are sold to both Muslim and non-Muslim investors throughout the world. The applicable laws will include those of the Shari'ah-incorporated jurisdiction, where the originator and the assets are located, particularly with respect to whether there has been a "true sale" of the assets by the originator to the special purpose issuer. The bankruptcy laws of both the jurisdiction where the originator and the assets are located and of the jurisdiction in which the issuer is located will be applicable to the transaction. Further, it is likely that the securities laws of the issuer's jurisdiction as well as those of the various jurisdictions of the purchasers of the sukuk will be applicable in certain circumstances.

It is noteworthy that in each of the illustrative transactions, the profit margins are quite thin and, for the most part, non-Islamic transactions of these types are quite standardized in terms of (a) the relative rights and remedies of the parties, (b) the terms of many financial and commercial risk allocations, and (c) the legal documentation. For example, in non-Islamic transactions the same forms of financing documents are used with minimal change from one transaction to the next. These documents have been used for many years and have been the subject of considerable interpretive litigation over the many years. Thus, there is great certainty and predictability as to how any provision will be interpreted or implemented as well as with respect to the rights, obligations, and remedies of all of the parties in a broad range of circumstances.

In the Shari'ah-compliant configuration of these transactions, the Shari'ah-compliant investor and the Shari'ah supervisory board are (of course) not indifferent to the issue of compliance with the Shari'ah. In fact, they desire to know with certainty and predictability that the Shari'ah will be enforced in this, as in any similar, transaction. The other participants in the transaction (including developers and financing banks) may well be indifferent to compliance with the Shari'ah, although they will undoubtedly not be indifferent to the effect compliance with the Shari'ah will have on their respective rights, obligations, and remedies, and on the degree of certainty and predictability inherent in the Shari'ah-compliant transaction.

In these types of Shari'ah-compliant transactions in the United States or Europe, and at the commencement of the transaction, all parties to the transaction have moved away from the state of certainty and predictability to which they are accustomed, and the non-Muslim participants are not close to the degree of certainty and predictability that they must have to enable them to determine whether to consummate the transaction. The Shari'ah-compliant investors are likely to be more comfortable with the structure of the transaction at its inception. (It will be an istisna'a-ijarah or sukuk structure that he or she has worked with previously, and these investors may also be quite familiar and comfortable with the applicable secular law.) The non-Muslim participants will be notably uncomfortable at this time: they will likely not know more than a few material points about the Shari'ah, and they will be using a structure that is totally unique to their experience, that is non-standard, and that is well outside their customary realm of certainty and predictability. Bankers, by nature and training being abhorrent of risks, particularly risks that they cannot control or understand, let alone risks that are unique to their experience, are usually the most uncomfortable participants in the reansaction.

Each of the participants in this transaction will look to the "law" governing this transaction to determine whether the agreed-upon rights and obligations of, and remedies available to, each of the parties (that is, the agreed-upon allocations of risks) will be sustained and enforced in a transparent, predictable and certain manner. A primary function of law, and we include the Shari'ah as "law" for the purposes of this chapter, in the commercial and financial realm is to provide certainty and predictability to the greatest possible extent and to sustain and enforce the determinations of the parties in a given transaction with respect to risk allocation and relative rights,

obligations, and remedies. These matters are the focus in respect of the enforceability of the Shari'ah in Islamic finance.

Of course, predictability, stability, and uncertainty are matters of individual perception based upon the past experience of the individual participants. For a range of reasons, the perceptions of most participants will be based upon financing techniques and structures that have been developed in the Western interest-based economic and legal system. Some of those reasons include (a) the dominance of the Western interest-based economic system over the last few centuries, (b) the predominance of United States and European financial institutions, lawyers, and accountants in the development and refinement of the most widely used financing techniques, (c) the refinement and exportation of Anglo-American law, (d) the relative infancy of modern Islamic finance, (e) the lack of familiarity with the operation of legal systems in the jurisdictions of the Islamic economic sphere, and (f) the general lack of knowledge of, and familiarity with, the Shari'ah. Those perceptions are also influenced by the existence of "standardized" practices and structures, including "standardized" contracts. applicable to many of the activities that comprise a financing. Those standardized practices, structures, and contracts have evolved, have become "standardized," because of the economic efficiencies that they facilitate, particularly with respect to risk allocation, risk coverage, and minimization of transactional costs. Of course, most of those standardized practices, structures, and contracts were developed in, and have evolved within, a Western interest-based paradigm and reflect little, if any, sensitivity to the principles and precepts of the Shari'ah. Similarly, the contracts will be enforced in a legal system that has developed and evolved in response to the needs of an interest-based economic system.

Each of the participant parties will come to the financing transaction bound by their existing institutional perceptions and practices with respect to such matters as risk allocation, risk coverage, underwriting criteria, and accounting treatment. Each must continue to operate within an existing secular legal and regulatory framework, and that framework has probably shaped many of the embedded institutional practices. Each participant party will have strong expectations, based upon past "best practices" within its realm of experience, as to the enforceability of the many contracts that comprise the project financing. Frequently, this means that parties will desire to have the contracts governed by English or New York law, rather than the law of the host country. Participants in Shari'ah-compliant transactions will include parties that proceed from, and are focused on, structures, methodologies, and documents that proceed from a Western interest-based perspective. However, almost by definition, these transactions will also include participants that proceed from a different set of principles and precepts: those embodied in the Shari'ah. Thus, in many cases, Shari'ah-compliant financings will utilize structures, methodologies, and documents that allow both Muslim and non-Muslim, particularly Western, parties to operate within a sphere of predictability, stability, and certainty that is acceptable to those parties.

Before examining issues pertaining to the enforceability of the Shari'ah in the context of modern Islamic banking and finance, it would serve us well to survey the aforementioned trends by way of sketching some recent developments that provide the context of discussion. In focusing on the issues pertaining to the enforceability of the provisions of a commercial or financial transaction that is structured in accordance with, and intended to be compliant with, the Shari'ah by the courts and other enforcement bodies of different jurisdictions, we need to consider (a) the types of jurisdictions in which such a transaction may occur and in which the related contracts may be enforced. (b) the state of the law in respect of enforcement and issues of governing law (particularly in purely secular jurisdictions), and (c) current practices in structuring and documenting such transactions. We examine each of these topics, and this examination includes consideration of the nature of legal opinions that are rendered in connection with such transactions.

#### 3.2. Internationalization and Globalization

Prior to the commencement of the modern era of Islamic banking and finance, interest-based banking and finance was dominant throughout the world, including in the Islamic economic sphere. While that remains true to this day as a general statement, this chapter has outlined the post-1970s development of a system of banking and finance that is compliant with the Shari'ah. The establishment of these early Islamic banks and financial institutions occurred on an international, but largely regional, basis and focused primarily on transactions between an Islamic bank or financial institution and its local customer base.

Legal systems in the various countries of the Islamic economic sphere were, and are, primarily secular, with exceptions such as those noted later in this chapter. Often, economic and legal structures were and are the product of legislation or royal decree, and some, if not most, of those structures and that legislation is unclear under, or conflicts with, or is contrary to, the Shari'ah, even in Shari'ahincorporated jurisdictions. However, most of those legal systems have some provision or conception that the Shari'ah is incorporated in the legal structure, frequently as "a" or "the" paramount law or source of law. Thus, there has been, and there remains, some question of whether, in what circumstances, and to what extent, the Shari'ah will be enforced in Shari'ah-incorporated jurisdictions within the Islamic economic sphere; the issue is joined, albeit quietly, and without the involvement of the Western economic sphere. Further developments during the modern era of Islamic banking and finance have ensured that the focus on enforceability is not now, and will not be, either quiet or isolated, and that the Western economic sphere will be forced to focus on the enforceability issue in tandem with the Islamic economic sphere.

In the mid- to late 1990s and the early years of this century, certain Middle Eastern investors sought to make investments in the Western economic sphere, particularly the United States, in accordance with the Shari'ah. Some of these investors were financial institutions and families that had long made investments in the United States, although many of those previous investments were not made in compliance with the Shari'ah, primarily because of the inability to effect, and perceived inability to enforce, Shari'ah-compliant transactions in the United States. Other investors were new to U.S. markets. And, as noted in the next section of this chapter, the products, structures, and transactions began rather simply and quickly became both more diverse and more sophisticated,

As an extension of this internationalization and globalization, and in response to political events during the period, the next major development began in late 2001, with acceleration in late 2002 and throughout 2003: Middle Eastern investors began to make Shari'ab-compliant investments in European jurisdictions on a significant scale. That trend continues to this day.

The salient point is that the making of Shari'ah-compliant investments in the United States and Europe was a broad international and more globalized trend. The transactions involved multiple jurisdictions and participants from a broad range of countries and religious, cultural, and legal systems. Many of the transactional participants, including the financing entities in the United States and Europe, had little or no familiarity with Islam or the Shari'ah. Yet, to give effect to the desires of the Muslim investors, the legal systems in the Western economic sphere had to address the issue of enforcing contracts in accordance with the Shari'ah, and, because of the structure of those legal systems, had to do so within the context of enforcement of conventional secular law, substantive and procedural, in those purely secular jurisdictions.

Of course, the question (a series of questions) is then dramatically posed: How can a Shari'ah-compliant investor or a Shari'ah supervisory board considering the structure of, or documentation for, a Shari'ah-compliant fund or transaction in the Western economic sphere be confident that the Shari'ah will be enforced? Can there be a truly Shari'ah-compliant transaction at all in the Western economic sphere if the relevant courts in the jurisdiction within the Western economic sphere will be applying the secular law of that jurisdiction in the interpretation and enforcement of the documentation for that transaction? Will a court in a Western economic sphere or a purely secular jurisdiction ever enforce the Shari'ah? How would a court in a purely secular jurisdiction within the Western economic sphere know what the Shari'ah is with respect to any matter or dispute? How does the injection of the Shari'ah into the secular law context affect the certainty and predictability of outcome that is essential to the effective operation of a legal system in a commercial world? Will financial institutions and non-Muslim transactional parties be willing to approve the enforceability of documents in accordance with the Shari'ah where they have essentially no knowledge of the Shari'ah and no confidence that there will be any contractual or economic certainty in a transaction where the Shari'ah is to be ascertained. interpreted, and enforced by a court in a purely secular jurisdiction within the Western economic sphere that likewise has no knowledge of the Shari'ah?

The questions quickly multiply, and are present in virtually every Shari'ah-compliant transaction in the international realm, and most particularly, but certainly not exclusively, in purely secular jurisdictions. These are critical questions to business people that desire minimization of risk, where possible, and depend upon a legal system that supplies certainty and predictability in commercial and financial transactions. The issues raised by these and related questions are exacerbated by the increasing diversification and sophistication of Shari'ah-compliant structures and products, particularly in an environment, such as the present environment, in which Shari'ah scholars

and others involved in Islamic banking and finance do not themselves agree on what is permissible under the Shari'ah in respect of innovative, novel, and sophisticated financial instruments.<sup>20</sup>

# 3.3. Diversification and Increased Sophistication of Products

Internationalization or globalization of Islamic banking and finance in the last 35 years has focused Shari'ah scholars, financial institutions, Muslim and Western business people, lawyers, accountants, and many others on the issue of the degree of certainty and predictability in Shari'ah-compliant transactions in comparison to the known degree of certainty and predictability in a conventional non-Shari'ah-compliant equivalent of that same transaction. The diversification of the base of Shari'ah-compliant products and the increasing sophistication of those products, all of which are highly "structured," while both in their infancy, have sharpened the focus further and brought the issue to the fore; they have brought sharply into focus the question of whether potential participants in these transactions will be amenable to spending further significant amounts in the development of Shari'ah-compliant structures and products.

The late 1990s saw pioneering efforts in the area of Shari'ah-compliant private equity investments in the United States. Those investments continue to this date and in more refined form throughout the world, including in the United States and in Europe. In 1998, Dow Jones obtained a fatwa pertaining to the financial tests applicable to Shari'ah-compliant investments in equity securities. With the downturn of the equity markets in the late 1990s and early years of this century, various Shari'ah-compliant investors moved forcefully in the United States' real estate markets. Investments were made in construction and development projects, first in the residential housing sector and later in commercial and mixed use projects.

During the period from 2001 to the present, there was a significant increase in Shari'ah-compliant investment in Europe, particularly pan-European real estate investments. There was also an increase in Shari'ah-compliant transactional activity in the United States during this period, although these transactions were done very discreetly, largely because of events in New York and Washington, D.C. in September 2001 and related developments. Shari'ah-compliant private equity funds also focused on both North America and Europe. Shari'ah-compliant structures for short sales of securities and options trading have been developed and fatawa have been issued in respect of

these structures. Efforts are under way to develop Shari'ah-compliant structures to effect the economic equivalencies of a range of derivatives. Shari'ah-compliant factoring and refactoring structures have been developed and approved by a Shari'ah supervisory board.

Notable aspects of developments in Islamic finance are the increased involvement of conventional Western financial institutions, the expansion of English-language literature on Islamic finance and Islamic jurisprudence, the access of the Shari'ah scholars to the principal business participants in the Western economic sphere, and the involvement of the Shari'ah scholars, from the very initial stages onward, in the structuring of financial Shari'ah-compliant products, including in the Western economic sphere. Early transactions in the United States and Europe were initiated by Middle Eastern or, to a lesser extent, Southeast Asian institutions that desired Shari'ah-compliant investments of their own funds and those of their depositors and other customers. The economics of those transactions required the use of leverage. Conventional Western financial institutions were brought into the transactions to provide the necessary leverage. However, the structures and documentation had to be designed in a manner that made the use of that leverage compliant with the Shari'ah. For a range of commercial and legal reasons, the only financial institutions that could or would provide the requisite leverage were Western financial institutions, particularly conventional interest-based banks. Those banks rose to the challenge and implemented the Shari'ah-compliant structures and documentation, largely because of their relationships with the Western institutions that were involved as developers, equity investors, and fund managers.

As Islamic finance has grown and the number of transactions has both increased and become more visible, Western financial institutions have shifted their focus. In the context of increasing globalization of their own businesses, they have recognized the size of the Islamic finance market and made a conscious decision to investigate participation in that market, not as a reflexive matter, but as an initiative matter. Their investigation has led them to the conclusion that it is possible, even practical, to develop structures that comply with, and meet the following desires, demands, and requirements: (a) the needs of their existing clients in the Islamic economic sphere; (b) their desire for global and international expansion and penetration of their own businesses; (c) their product strengths and capabilities; (d) the Shari'ah; and (e) local secular legal requirements. Thus, various conventional Western financial institutions are taking the initiative in

developing their own Islamic finance programmes, and some of these programmes are at the forefront of Islamic finance. These banks desire to play to their own strengths, such as derivatives. Frequently, these strengths are in areas in which there are, at present, no Shari'ab-compliant structures. Additionally, these institutions desire products that compete in the conventional as well as the Islamic finance markets. The result is substantial pressure to create a broader range of much more sophisticated financial instruments and products.

#### 3.4. Public Law and Private Law in Different Jurisdictions

Focusing on the concept of the application of the Shari'ah to contractual relationships between two or more sophisticated parties to a commercial or financial transaction, and as a general statement, there are two types of jurisdictions: the Shari'ah-incorporated jurisdictions and the purely secular jurisdictions. Examples of Shari'ah-incorporated jurisdictions include Egypt, Iraq, Jordan, Kuwait, Saudi Arabia, Syria, the United Arab Emirates, and Yemen. Examples of purely secular jurisdictions include the United States, the United Kingdom, France and most European jurisdictions, Japan, and South Korea.

The degree to which the Shari'ah has been incorporated into the substantive law of the various Shari'ah-incorporated jurisdictions varies considerably.30 Historically, the Ottoman Empire adopted many aspects of the French commercial code by 1830, and thereafter adopted many other French codes. Civil law remained largely untouched by this Westernization process despite the compilation of the Majelle. The Majelle was a codification of civil law following a Western model, but the Majelle itself was comprised of, and based upon, the Shari'ah as interpreted by the Hanafi school of Islamic jurisprudence. Since 1949, Egypt and Syria have adopted Westernized codifications of certain laws, while retaining the influence of the Shari'ah in many substantive areas. In each of these jurisdictions, the Shari'ah is expressly designated as a source of law. In Egypt, the Shari'ah is to be consulted by a judge after considering the civil code and custom. In Svria, the Shari'ah is to be consulted prior to examination of custom, and is thus a true source of law. Similar concepts are found in the Civil Code of 1976 of Jordan. Kuwait and the United Arab Emirates are examples of nations that have incorporated significant portions of the Shari'ah into their codes. In certain jurisdictions, such as Saudi Arabia and Oman, there is no civil code

and the role of the Shari'ah is predominant, including in respect of contracts.31

The distinction between Shari'ah-incorporated jurisdictions and purely secular jurisdictions is important in addressing the issue of when, and under what circumstances, the Shari'ah is an enforceable element of a contract under the laws of a specific nation or jurisdiction.<sup>32</sup>

In the Shari'ah-incorporated jurisdictions, provisions of the Shari'ah are either (a) literally incorporated into the text of the substantive law of the nation; or (b) incorporated as an interpretive matter by the courts or other enforcement bodies. In either case, a contract that is governed by the law of the Shari'ah-incorporated jurisdiction will be enforced in accordance with the Shari'ah, to the extent that the Shari'ah is so incorporated and applicable, and whether or not the specific substantive legal provisions are referenced in the contract. Thus, in a Shari'ah-incorporated jurisdiction the parties cannot by contract alter the applicable Shari'ah provisions, nor will it be necessary for the parties to specifically incorporate applicable Shari'ah provisions. (They will be incorporated into the contract by operation of law.)

In a purely secular jurisdiction, on the other hand, the governing law, of itself, will not include any of the Shari'ah, Sophisticated parties to a commercial financing transaction are permitted to write their own "law" for the transaction, in the form of the contract, and the contract itself is "the law of the land" with respect to that transaction.33 Thus, if the parties desire to implement the Shari'ah, they will have to draft the contract in accordance with, and incorporate, the relevant Shari'ah principles. If New York or English law, or the law of any other purely secular jurisdiction, is chosen as the governing law of a contract, the court will enforce that law, and the contract subject to that law, in accordance with its terms. If the contract in question is drafted in accordance with the Shari'ah (for example, to include, as text, the relevant Shari'ah principle), the New York or English court, applying New York or English law, will enforce the Shari'ah provisions. Alternatively, but with less certainty and predictability.34 the parties to a contract in a purely secular jurisdiction could choose to apply the law of a Shari'ah-incorporated jurisdiction, and thereby ensure that the contract would be enforced in accordance with the Shari'ah to the extent that the Shari'ah is incorporated in, or comprises a part of, the laws of such Shari'ah-incorporated jurisdiction.

# 4. ENFORCEABILITY OF THE SHARI'AH: CASE LAW AND TRANSACTIONAL PRACTICE

In analyzing the issues pertaining to enforceability, under the Shari'ah, of provisions of contracts in Shari'ah-compliant transactions, it is necessary to consider a number of factors, including: (a) existing law, including case law in common law jurisdictions; (b) current transactional practice relating to the construction and drafting of contracts in Shari'ah-compliant transactions in different jurisdictions; (c) current transactional practice with respect to legal opinions; and (d) the matters of certainty and predictability in Shari'ah-compliant transactions in different jurisdictions. In considering these factors, this chapter makes the assumptions that the transactions that are discussed have been structured and documented in accordance with the Shari'ah and that such structures and all documentation have been reviewed and approved by a Shari'ah supervisory board.

# 4.1. Shamil Bank v Beximco: A Recent English Court Decision

Focusing on enforceability issues in purely secular jurisdictions, such as England, other European jurisdictions, and the United States, litigation of a Shari'ah-compliant transaction using the law of the purely secular jurisdiction as the governing law will raise questions of whether, when, and under what circumstances a secular court will apply the Shari'ah in interpreting the contracts involved in that transaction. A recent appeals court decision in an English case. Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco Pharmaceuticals Ltd. and Others ("Shamil Bank v Beximco"),35 focuses on the enforceability issue in the context of a Shari'ah-compliant transaction in which the governing law provisions of the relevant legal contracts contained the following language: "Subject to the principle of the Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England." This case provides a good starting point for achieving an understanding of how enforceability issues are addressed in a purely secular jurisdiction.

In 1995, two companies in the Beximco group of companies (the "Beximco Companies") executed a murabahah agreement (the "1995 Murabahah Agreement") with Shamil Bank pursuant to which Shamil Bank advanced funds to the Beximco Companies for the purchase of specified goods. The 1995 Murabahah Agreement was guaranteed by two directors of the Beximco Companies and by the

parent company of the Beximco Companies (the "Guarantors"). One of the Beximco Companies made several payments under the 1995 Murabahah Agreement in accordance with a payment schedule to that agreement. In 1996, the Beximco Companies entered into a second murabahah agreement (the "1996 Murabahah Agreement") with Shamil Bank, and funds were advanced pursuant to the 1996 Murabahah Agreement. The second of the Beximco Companies made various payments to Shamil Bank pursuant to the 1996 Murabahah Agreement and its related payment schedule.

By late 1999, both Beximco Companies were in admitted default under the 1995 Murabahah Agreement and the 1996 Murabahah Agreement (collectively, the "Murabahah Agreements"). In 1999, the Beximco Companies entered into two Exchange in Satisfaction and User Agreements with Shamil Bank, and these were later amended in 2001 and 2002 (as amended, the "Ijarah Agreements"). Pursuant to the Ijarah Agreements, certain assets of the Beximco Companies were transferred to Shamil Bank in satisfaction of the Murabahah Agreements, the Beximco Companies were granted the right to use those transferred assets, and the Beximco Companies agreed to make payments to Shamil Bank in respect of such use. Each of the Ijarah Agreements was guaranteed by the guarantors.

Pursuant to the constitutional documents of Shamil Bank, <sup>36</sup> the Shari'ah supervisory board of Shamil Bank ascertains that the "investments and activities" of Shamil Bank conform to the Shari'ah. The Shamil Bank board of directors has the responsibility, pursuant to the constitutional documents, to "ensure that all the investments and other business transactions [of the Bank] have been referred" to the Shari'ah supervisory board. It is not clear from the reported decision whether or not the Shari'ah supervisory board of Shamil Bank reviewed the precise transactions, and related documentation, pertaining to the Murabahah Agreements, the Ijarah Agreements, and the related guarantees. This presumably would be a factual matter to be determined at a trial.

In mid-2002, both of the Beximco Companies were in default under the *Ijarah* Agreements and defined "termination events" had occurred thereunder. Shamil Bank provided notices of default and made claims for approximately US\$49.7 million on the *Ijarah* Agreements and the guarantees provided by the guarantors. The lower court awarded judgment to Shamil Bank for approximately US\$49.7 million. The lower court determined that it was not necessary to concern itself with *Shari'ah* principles.

The governing law provision of each of the *Ijarah* Agreements reads: "Subject to the Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England." The governing law provision of each of the guarantees reads that such guarantee: "is governed by and shall be construed in accordance with English law" (there being no reference to the *Shari'ah*).

The critical issue at the appellate court level, as well as at the lower court level, in *Shamil Bank v Beximco* was whether the governing law clause in the *Ijarah* Agreements required the consideration of the *Shari'ah*. The appellate court, like the lower court, determined that the governing law clause did not require consideration of the *Shari'ah*.

The appellate court opinion begins by noting that an English court must interpret a contract in accordance with the commercial purpose of the parties and the contract, and must thus take cognizance of "the genesis of the transaction, the background, the context, the market in which the parties are operating" and similar factors. 37 In the instant case, this requires recognition of the fact that the contracts at issue (that is, both the Murabahah Agreements and the liarah Agreements) were intended to provide working capital financing with long-term repayment provisions and were to be binding upon the parties to those contracts. Further, and in accordance with that same principle in respect of commercial purpose, the court noted that "insofar as each of the clauses provides in clear terms that 'this agreement shall be governed by and construed in accordance with the laws of England', the proviso that such provision shall be 'subject to the principles of the Glorious Sharia'a' should be approached on a basis which is reconcilable with the purpose evident from the words which follow, rather than operating to defeat such purpose."38

Turning to the governing law issues, the court noted that there can be only one law governing enforceability of the provisions of the contracts at issue. By concession in this case, that law is the law of England and not both English law and the Shari'ah. The opinion notes that the Rome Convention has the force of law in the United Kingdom, and that the Rome Convention allows the parties to a contract to choose the law applicable to that contract, but that the law so chosen must be the law of a country. The court also notes that Article 1.1 of the Rome Convention is not on the face of it applicable to a choice between the law of a country and a non-national system of law, such as the lex mercatoria, or 'general principles of law', or as in this case, the law of Sharia, '42 Concurring with the lower court, the appellate court characterizes the Shari'ah

as a set of "Islamic religious principles" 43 and "religious and moral codes," 44 rather than laws of a nation.

The opinion then addresses the concept that the law of a nation (such as England) may govern a contract, but that contract may incorporate provisions of another foreign law or a set of rules as terms of the contract whose enforceability is to be determined by such national law. The opinion cites examples that are discussed in a leading text on conflicts of laws, Dicey & Morris, as put forth by the Beximco Companies: 45

32-086... it is open to the parties to an English contract to agree e.g. that the liability of an agent to his principal shall be determined in accordance with the relevant articles of the French Civil Code. In such a case the foreign law becomes a source of law upon which the governing law may draw. The effect is not to make French law the governing law of the contract but rather to incorporate the French articles as contractual terms into an English contract. This is a convenient "shorthand" alternative to setting out the French articles verbatim. The court will then have to construe the English contract, "reading into it as if they were written into the words" of the French statute.

32-087 It often happens that statutes governing the liability of a sea carrier, such as the former Harter Act in the United States, or statutes implementing the Hague Rules ... are thus "incorporated" in a contract governed by a law other than that of which the statute forms a part. The statute then operates not as a statute but as a set of contractual terms agreed upon between the parties. The parties may make an express choice of one law (e.g. English law) and then incorporate terms of a foreign statute. In such a case the incorporation of a foreign statute would only have effect as a matter of contract.

While stating that the foregoing was of no assistance to the Beximco Companies, the court acknowledged the application of the principle that the governing law of a contract may be that of one nation (England or the United States), while "incorporated contractual terms" may come from another body of law or rules (such as the French Civil Code, the Hague Rules or, possibly, and by implication,

the Shari'ah). However, as noted by the court, 46 such an incorporation concept is only workable "where the parties have by the terms of their contract sufficiently identified specific 'black letter' provisions of a foreign law or an international code or set of rules apt to be incorporated as terms of the relevant contract such as a particular article or articles of the French Civil Code or the Hague Rules. By that method, English law is applied as the governing law to a contract into which the foreign rules have been incorporated."

Turning to the instant case, the opinion finds that the generality of the incorporation of contractual terms, if any, pursuant to the phrase "[s]ubject to the Glorious Sharia'a" is insufficient to identify specific black letter provisions of the Shari'ah, and thus ineffective.

The general reference to principles of Sharia in this case affords no reference to, or identification of, those aspects of Sharia law which are intended to be incorporated into the contract, let alone the terms in which they are framed. It is plainly insufficient for the defendants to contend that the basic rules of the Sharia applicable to this case are not controversial. Such "basic rules" are neither referred to nor identified. Thus the reference to the "principles of ... Sharia" stands unqualified as a reference to the body of Sharia law generally. As such, they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless.<sup>47</sup>

Finally, so far as the "principles of ... Sharia" are concerned, it was the evidence of both experts that there are indeed areas of considerable controversy and difficulty arising not only from the need to translate into propositions of modern law texts which centuries ago were set out as religious and moral codes, but because of the existence of a variety of schools of thought with which the court may have to concern itself in any given case before reaching a conclusion upon the principle or rule in dispute. The fact that there may be general consensus upon the proscription of Riba and the essentials of a valid Morababa agreement does no more than indicate that, if the Sharia law proviso were sufficient to incorporate the principles of Sharia law into the parties' agreements, the defendants would have been likely to succeed. However, since I would hold that

the proviso is plainly inadequate for that purpose, the validity of the contract and the defendants' obligations thereunder fall to be decided according to English law. It is conceded in this appeal that, if that is so, the first and second defendants [that is, the Beximco Companies] are liable to the Bank.

#### 4.2. Discussion

Before moving to other aspects of enforceability in the context of a Shari'ah-compliant transaction, it is worth noting a few aspects of the reasoning in the Shamil Bank v Beximco case.

First, in accordance with conceptions of national sovereignty and the concepts of nations, the near universal principle is that the law governing a contract (and most other matters) is the law of a nation as precisely defined in that nation. This law will include both substantive legal principles, such as with respect to the nature of contracts and their interpretation, and procedural laws, such as with respect to how a given claim is brought in the courts of that nation or enforced under the laws of that nation. As noted in this chapter, certain jurisdictions, the Shari'ah-incorporated jurisdictions, do incorporate the Shari'ah into the national law, either generally or in specific instances. However, even in Shari'ah-incorporated jurisdictions, the degree of incorporation varies considerably and is often general rather than specific. As a general, and near universal matter, national law will govern the interpretation of contracts.

Second, the laws of many nations allow the parties to a contract to choose the law that will be applicable to the enforcement of that contract. The Rome Convention that is cited in the Shamil Bank v Beximco opinion is one of the most significant embodiments of that principle. In most legal systems, there are "conflicts of laws" and "choice of laws" concepts that address the circumstances in which different governing laws may be chosen and enforced. A Again, there are variations in this concept, especially as regards enforcement of foreign judgments obtained in foreign courts or under foreign law and as regards the concept of "public policy" of a given nation as it relates to the structuring and enforcement of contracts.

Third, as a general matter, the laws of many nations allow the parties to a contract to incorporate foreign laws, codes, and rules into a contract governed by the laws of such nation, although they also require some degree of specificity to effect that incorporation. Any such incorporation is usually considered to be an incorporation of specific contractual terms, rather than a modification of the governing law provision itself. The ruling in Shamil Bank v Beximco is consistent with those principles. The court in Shamil Bank v Beximco implied that it would have no objection to the incorporation of specific aspects of the Shari'ah, analogously to incorporation of the French Civil Code, the Hague Rules, or the Harter Act, if there were adequate specificity of the terms to be incorporated. This is consistent with the laws of the States of the United States and of most European jurisdictions.

Fourth, generally the laws of most nations allow the parties to a contract, particularly a commercial contract between sophisticated parties, to agree to such contractual terms and conditions as the parties determine appropriate. Of course, there are certain limitations, such as those pertaining to illegal acts or acts contrary to public policy, which cannot be the subject of a valid and enforceable contract. Another set of limitations relates to contractual contravention of a paramount law, such as a constitution or the *Shari'ah* itself. Similarly, there are unwaivable and mandatory legal provisions in the laws of most nations, particularly in respect of matters where the sophistication and bargaining power of the parties are disparate. Examples of the latter type of provisions include certain consumer protection, environmental protection, landlord—tenant, and public policy laws that may not be altered or waived by contract.

## 5. TRANSACTIONAL PRACTICE: LEGAL OPINIONS

## 5.1. Legal Opinions in Financing Transactions Generally

In almost every financial transaction, including Shari'ah-compliant transactions, the parties will require that their counsel or opposing counsel provide a series of legal opinions. One set of legal opinions will address the due formation and valid existence of the participating entities under relevant applicable law. This threshold set of opinions is generally referred to as the "entity authority" set of opinions. Another set of opinions, and those that are the focus of this chapter, will address the validity and binding effect, and enforceability, of the relevant documents. This set of opinions is generally referred to as the "enforceability" or "remedies" set of opinions. An example of an enforceability opinion for a Shari'ah-compliant ijarah-based

acquisition financing transaction in a purely secular jurisdiction (here, New York) is set forth as Exhibit A at the end of the chapter.<sup>50</sup>

## 5.2. The "Enforceability" or "Remedies" Opinion

"A remedies opinion deals with the question of whether the provisions of an agreement will be given effect by the courts." The essence of the enforceability or remedies opinion is that each of the "undertakings" in the contracts to which the client is a party is enforceable under the designated law governing the contracts, and the standard formulation is that "the agreements are valid and binding obligations of the Company, enforceable against the Company in accordance with their terms." This opinion is customarily delivered at the closing of the transaction, and its delivery is usually a condition precedent to the closing of that transaction.

As noted in the TriBar Report, 54 the remedies opinion covers three distinct, but related, matters:

- (a) it confirms that an agreement has been formed;
- it confirms that the remedies provided in the agreement will be given effect by the courts; and
- (c) it describes the extent to which the courts will enforce the provisions of the agreement that are unrelated to the concept of breach.

Exceptions and exclusions to the opinion are appropriate in various circumstances, and those exceptions and exclusions are set forth in the opinion itself. (Exhibit A provides examples of a wide range of exceptions and exclusions.) For example, one or more exceptions may be required in respect of the portion of the opinion described in clause (b) above if either (i) under applicable law the opinion recipient will not have a remedy for a breach of any "undertaking" by the other party to the agreement, or (ii) a remedy specified in the agreement will not be given effect by the courts under the circumstances contemplated. An example of the latter circumstance is the concept of "specific enforcement" as being a remedy under a contract. As noted in the TriBar Report, 50 this means "as a practical matter, that a court will consider whether to provide specific performance as a remedy" and not that the court will grant specific performance.

The types of "undertakings" to which the remedies opinion relates may be summarized into three groups. The first group (the "obligations provisions") is those provisions of the agreement that obligate the company to perform an affirmative act, but say nothing about what will happen if it fails to perform those acts. An example from an ijarah-based transaction is the requirement in the ijarah that the lessee pay rent. As applied to these provisions, the enforceability opinion "means that a court will either require the Company to fulfill its undertakings as written or grant damages or some other remedy in the event of a breach." 56

The second group (the "available remedies") is those provisions that specify a remedy if the company fails to perform particular undertakings. The stated remedies may be affirmatively stated (for example, the requirement to pay liquidated damages) or, more frequently, set forth as the right of a party to take action (for example, reduce the interest of a defaulting partner in a partnership or exercise a put option or sell certain property). "For those provisions, the remedies opinion means that a court will give effect to the specified remedies as written." "57"

The third group (the "ground rules provisions") is those provisions that establish the basic rules for interpreting or administering an agreement and settling disputes under that agreement. Examples include the statements (which are actually undertakings of both parties) with respect to the choice of governing law, the forum for dispute resolution (for example, the New York courts or by arbitration), the manner in which notices are effectively given or binding amendments effected (for example, in writing), or the waiver of rights (for example, the waiver of the right to jury trial). "Unless excepted from the opinion, these provisions are covered by the remedies opinion, which is understood to mean that a court will give effect to the provision as written and require the Company to abide by its terms." 58

# 5.3. Enforceability Opinions in Specialized Financing Transactions

Enforceability or remedies opinions in specialized financing transactions are subject to considerations that are not applicable to other enforceability opinions. On The types of transactions that are "specialized financing transactions" are not specified in the TriBar Specialized Financing Report. The examples given are leveraged leases and sale-leaseback transactions, and other transactions that are "reasoned."

A good argument can be made that many Shari'ah-compliant transactions in a purely secular jurisdiction should, and would, qualify as "specialized financing transactions" for purposes of the TriBar Specialized Financing Report (and the "Accord," as defined therein, of the American Bar Association). These transactions involve a significant degree of structuring, the use of multiple agreements to effect the structure, the necessity of considering the entire set of project documents and financing agreements as a totality to clearly understand the agreement of the parties, the disregard of certain of the entities involved for the purposes of some laws (such as the disregard of the funding company special purpose vehicle used in many of these transactions as a taxable entity), and multiple characterizations of the transaction. (For example, the tax matters agreement used in many of these transactions will state that the transaction as a whole is a loan transaction from the Facility Agent (lender) to the Project Company (into which the Shari'ah-compliant investment is made) for purposes of the federal income tax laws of the United States, and possibly for certain environmental laws allowing a lender a "safe harbor" in financing transactions.)

Because of the similarities of most Shari'ah-compliant transactions with the stated concept of "specialized financing transactions" in purely secular jurisdictions, various legal issues in respect of enforceability should be explicitly addressed as contemplated by the TriBar Specialized Financing Report.

# 6. SUKUK: CAPITAL MARKETS AND SECONDARY MARKETS

### 6.1. Market Functions and Market Factors

Law, in its practical application, has a profound influence on the form of Islamic finance. Most obviously, the influence is felt at the level of individual contracts and the structure of individual transactions. The previous two sections of this chapter have summarized some of those effects. Of even greater significance are the influences of the law, direct and indirect, on the viability and structure of the capital markets, including secondary markets. A particularly poignant case in point relates to an area of Islamic finance that is in its earliest stages of development: the *sukuk*.

Sukuk are of two general types: Islamic bonds and securitizations. Islamic bonds are based upon the credit of an entity that is participating in the transaction, such as the issuer, a guarantor, or another provider of credit support. Securitizations involve a transfer of assets

from an originator into a trust or similar special purpose vehicle (SPV) with the issuance of securities by that trust or SPV. Payments on the issued securities (the sukuk) are derived solely from the payments received in respect of those transferred assets, rather than any general credit of an issuer or participating party. Thus, securitizations are based upon the credit of the securitized assets. To date, most sukuk issuances have been Islamic bond issuances. True securitization sukuk issues are rare, and issues of this type that have been rated by a major international rating agency are nonexistent.

While both types of issuances access the capital markets and are necessary for balanced growth of the capital markets, true securitizations have benefits that transcend those available from bond issuances alone. Securitizations allow, often require, broad diversification of the assets in the securitized pool. The originator of the transferred assets uses the securitization to manage its balance sheet and capital structure. The originator transfers assets that generate deferred payments and receives an immediate cash payment from the capital markets in respect of that transfer. This enables the originator to immediately generate more assets and results in further diversification of the financing in respect of the transferred assets and access to a broader financing base. The securitization process allows greater risk management and liquidity management for all market participants. It facilitates regulatory and conduit funding arbitrage. At a broader market level, the securitization process has proven itself as a critical backbone of both the capital markets and, in particular, the development, existence, and functioning of secondary markets. Given the immaturity of capital markets and secondary markets in the Islamic economic sphere, and recent enthusiasm for sukuk issuances, securitizations, and the legal and structural support for securitizations, should be areas of primary focus for the entire Islamic finance industry.

In order to develop strong securitization capability and related secondary markets, significant market depth must be obtained. Programme issuers are a critical component, and those issuers must generate considerable volumes on a constant basis. Programme issuers should include both governmental organizations and private financial institutions. Historically, governmental and quasi-governmental institutions have been critical to the development of securitization markets and related viable secondary markets. In the United States, institutions such as FNMA or Fannie Mae (Federal National Market Association), Freddie Mac (Federal Home Loan Mortgage Association), GNMA or Ginnie Mae (Government National Mortgage

Association), and SLMA or Sallie Mae (Student Loan Marketing Association), and similar quasi-governmental agencies, have been particularly effective in helping to establish broad secondary markets and in otherwise realizing the benefits of securitization. For example, the participation of these entities in the securitization markets has helped to develop the relevant legal and regulatory framework, has fostered and overseen the development of standards and standardized documentation, and has helped to generate volume and depth of the markets. Governments and quasi-governmental agencies have acted as regulators, enablers, issuers, and purchasers of securitized instruments and related securities, with profound effects on the capital and secondary markets and the effectuation of monetary policy.

Securitization in the field of Islamic finance is subject to a range of inhibitors that will need to be addressed and with respect to which structural accommodation is necessary. One such inhibitor is the considerable fragmentation of the relevant markets. These markets are fragmented with respect to, among other factors, (a) countries, (b) currencies, (c) the state of legal and regulatory development, (d) the degree of elucidation of, and agreement on, applicable Shari'ah standards, and (e) the operation of both Islamic and conventional interest-based markets in the same space. Another inhibiting factor is the lack of scale in the Islamic finance field at the present time. A third set of inhibitors relates to a range of uncertainties with respect to the legal and regulatory base for securitizations and capital markets generally. Consider, for example, the state of development of securities laws in many of the jurisdictions within the Islamic economic sphere. And, with respect to fundamental market criteria, the markets within those jurisdictions are underdeveloped and characterized by illiquidity, excessive concentration of risks, and lack of specialization. Yet another inhibiting factor is the scarcity of human resources, such as qualified Shari'ah scholars and experienced financial, legal, accounting, and other professionals of all types.

# 6.2. Legal Infrastructure: Systemic Factors Pertaining to Enforcement

The general structure of each of the relevant legal systems is of primary relevance to the ability to effect securitizations and thus to the growth and development of capital markets and secondary markets within those capital markets.<sup>61</sup> As noted elsewhere in this chapter, certainty and predictability are essential elements of any legal and

financial system, as are transparency and consistency. As a systemic matter, some of the key structural elements that are of relevance are (a) whether the relevant legal system is based upon a system of binding precedents, (b) whether legal and arbitral decisions, and the rationale for those decisions, are published and widely available, (c) whether the judicial structure is responsive to continuity and consistency in the application of judicial precedents, and (d) the time frame for enforcement of remedies within the system.

While these systemic factors are not treated in detail in this chapter, suffice it to say that many of the key structural elements are absent or insufficiently developed in jurisdictions within the Islamic economic sphere. The concept of binding precedent is often totally absent. Decisions are rarely published. In many jurisdictions, each case is considered de novo and without regard to other decisions that have been rendered in similar cases. Judges and other adjudicators are afforded wide discretion in determining cases. And the time frame for enforcement is frequently so long that it precludes effective remedies in fast-moving markets such as the capital markets. Each of these factors is frequently cited by international securitization and capital markets institutions as a reason for their reluctance to engage in capital markets initiatives in the Islamic economic sphere. These are substantial impediments to growth of the securitization markets (and thus the capital markets, including secondary markets) in these jurisdictions and there should be immediate focus on the removal, or a satisfactory alleviation, of these impediments.

## 6.3. Legal Infrastructure: Specific Legal Issues

Realization of the benefits of securitization for Islamic finance and the Islamic economy will require continuous issuances of asset-based sukuk by the private sector. This cannot be achieved without having those issuances rated by the major international rating agencies. Obtaining those ratings, in turn, is dependent upon obtaining the requisite legal opinions from prominent law firms engaged in these issuance transactions. These observations indicate that consideration of the ratings analysis used by the major ratings agencies is a useful paradigm for studying the legal issues that will affect the development and growth of the capital markets, particularly the secondary markets, insofar as those markets are influenced by sukuk issuances. The analytical framework and criteria used by the major ratings agencies are well developed and highly refined.<sup>62</sup>

As a generic matter, and in its simplest form, a securitization involves (i) an originator of assets, (ii) an issuer of the sukuk or other instrument, which is a trust or SPV, (iii) a parent of the issuer, (iv) a payor or payors in respect of the assets being securitized, and (v) a purchaser-holder of the sukuk or other securities. The originator of the assets transfers, by sale, the assets to be securitized into the issuer. The issuer sells sukuk or other instruments to the purchaser and uses the proceeds of that sale to pay the originator for the transferred assets. Over time, the payor or payors make payments to the issuer who then transfers those payments to the sukuk purchaser as the holder of the sukuk. The issuer provides collateral security over the assets to the sukuk holders to secure the payment of the sukuk.

In determining whether and how to rate a securitization, rating agencies examine (i) the credit quality of the securitized assets (and, at least as a statistical and underwriting matter, the payors with respect to those assets) and any other available credit support, (ii) the structure of the securitization transaction, and (iii) the legal opinion as to the structure and its key elements. As a general matter, the securitized assets must be isolated for the benefit of the sukuk holders. In the simplest case, the critical elements are: (a) that all rights, title, interest, and estate in and to the securitized assets are transferred by the originator to a bankruptcy remote SPV; and (b) that SPV grants a first priority perfected (or perfectible) security interest over those assets to secure payments on the sukuk and other claims of the sukuk holders.

The foregoing requires careful examination of (1) the transfer of the assets from the originator to the SPV, and (2) the priority, perfection, and enforceability of the security interests granted in the securitized assets provided as collateral for the benefit of the *sukuk* holders. This examination is made through review of the documentation and through the obtaining of a legal opinion that addresses all of the transactional issues. Looking to the primary substantive legal opinions, <sup>63</sup> the following are the primary areas addressed by the legal opinions:

- (a) true sale of the securitized assets
- (b) non-consolidation of the assets in bankruptcy
- (c) bankruptcy remoteness
- (d) the collateral security structure
- (e) enforceability of the transactional documents
- (f) choice of law
- (g) enforcement of judgments and awards.

### 6.4. True Sale

The true sale opinion addresses the issue of whether the SPV that is the issuer of the *sukuk* owns the transferred assets – that is, whether there was a valid transfer. The transfer must be such that it cannot be recharacterized by a court or other body as a secured loan or otherwise avoided in a bankruptcy or insolvency proceeding involving the originator of the assets (such as pursuant to a fraudulent transfer in anticipation of bankruptcy or a preference payment). The bankruptcy or insolvency of the originator should not affect the assets that have been transferred to the issuer SPV. This, in turn, means that the issuer will be able to enforce collection and other rights against the payor without hindrances resulting from the bankruptcy or insolvency of the originator.

Further aspects of the true sale doctrines relate to the nature of the title transferred to the issuer. Many securitizations involve an unperfected transfer of an equitable interest in the assets (in some cases, so as to avoid legal requirements pertaining to notification of the payor). The transfer must then be perfectible at the election of the issuer. Shari'ah scholars have differing views on the permissibility of separation of legal and equitable title to assets, and these raise impediments to effectuation of securitizations in certain unperfected transfer structures. If separation of legal and equitable title is not permissible, legal title would have to be transferred in a manner that satisfies all of the applicable perfection requirements (including notification of the payor).

Another aspect of the sale analysis (although technically not having an effect on whether a true sale exists) pertains to whether the assets are transferred free and clear of all prior overriding liens. This also will be considered in the relevant legal opinions and is a critical ratings criterion.

#### 6.5. Non-consolidation

A second legal opinion analysis focuses on the bankruptcy of two entities: the originator and the parent of the issuer SPV. In brief, the requirement is that the securitized assets held in the issuer will not be consolidated with the assets of the originator or the issuer parent in a bankruptcy or insolvency of either of those entities. The "separateness" covenants discussed in the next section pertain to the non-consolidation opinion as well as bankruptcy remoteness.

## 6.6. Bankruptcy Remoteness

Another area of the ratings criteria relates to the remoteness of the bankruptcy of the issuer SPV. The focus is on reduction of the possibility of a bankruptcy of the issuer. The main reason for concern is that, in many jurisdictions, if there were a bankruptcy of the issuer the assets of the issuer would be distributed in accordance with law or a court order rather than in accordance with the contractual arrangements involving the issuer. Further, there would likely be mandatory stay provisions during the pendency of any issuer bankruptcy, which would interfere with timely payment of the sukuk. Therefore, the transaction is structured to make initiation of a bankruptcy proceeding against the issuer as unlikely as possible.<sup>64</sup>

The first set of documentary provisions relating to bankruptcy remoteness restricts the purpose and activities of the issuer SPV. This is accomplished by restricting the business purpose of the issuer exclusively to the sukuk transaction. Correlative provisions prohibit various activities. Rating agencies frequently require that these provisions be included in both the constitutive documents of the issuer and the transactional documents for the sukuk transaction. The required legal opinion will then have to indicate that the constitutive document provisions will be binding upon third parties.

Separateness covenants will be required to further ensure bankruptcy remoteness (as well as non-consolidation). Most major rating agencies suggest covenants that require the issuer to:

- (a) maintain a separate office
- (b) keep separate corporate records
- (c) hold separate board of directors meetings in accordance with specific schedules and legal requirements
- (d) not commingle assets with any other entities
- (e) conduct business in its own name
  - (f) provide financial statements that are separate from other entities
- (g) pay all liabilities out of its own funds
- (h) maintain strict arm's-length relationships with parent and affiliated entities
  - (i) not issue any guarantees
- (j) use its own stationery, invoices, checks, and other documents and instruments

- (k) not pledge its assets for the benefit of any other entity
- (l) hold itself out as separate from its parent and affiliates.

Securitization counsel often interpret rating agency guidelines to require that the foregoing covenants be included in the constitutive documents of the issuer as well as the transactional documents.

A number of issues arise with respect to the separateness covenants in a Shari'ah-compliant transaction. First, many law firms have taken the position that the separateness covenants should apply to, and be required of, the issuer and, where the securitized asset is an ijarah in a Shari'ah-compliant ijarah-based structure, the funding company lessor and the project company lessee. In such a structure, the funding company is, by intention, a disregarded entity for tax purposes and makes no decisions or determinations of its own accord - it is an entirely passive entity that undertakes a borrowing and acts as a lessor of the property in which a Shari'ab-compliant investment is made. In such a structure, many, if not most, of the separateness covenants are not true on their face. Assets of the funding company and the project company are commingled. Frequently, the financial statements of the project company (the entity of substance) are combined with those of the funding company. The funds of the project company are used to pay all liabilities, including those of the funding company. And the assets of the funding company and the project company are pledged to secure the obligations of each and both. Second, 65 if these covenants are included in the constitutive documents, any breach (however minor or immaterial) of the covenants will constitute an ultra vires act and the members of the board of directors of the breaching company may be personally liable in respect of that breach. Given that bank officers and other primary market participants are frequently directors of the project company in Shari'ah-compliant transactions, there has been significant resistance to securitization transactions if counsel requires inclusion of these covenants in the constitutive documents of the project company.

Yet another set of provisions to ensure bankruptcy remoteness relates to non-competition and bankruptcy declarations. The originator, investors, credit enhancers, and others agree in the transaction documents not to initiate involuntary bankruptcy proceedings against the issuer. The issuer also provides, in both its constitutive documents and the transaction documents, not to initiate voluntary bankruptcy proceedings.

## 6.7. Collateral Security Structure

Consideration of the collateral security structure is a critical factor under the ratings criteria, and the subject of legal opinions. The focus is on the security interests provided for the benefit of the *sukuk* holders. Those security interests must be the first priority (there can be no prior claims and no subsequent claims) and perfected (or perfectible). The legal opinions must address the nature of the security interest, the enforceability of the security interest against third parties, and perfection requirements (such as notices, registration, and recordation). The effects of bankruptcy on perfection must also be considered and opined upon.

A number of significant issues arise in jurisdictions within the Islamic economic sphere. First, rahn (mortgage and pledge) concepts in certain of these jurisdictions are possessory in nature (pursuant to the Shari'ah). This makes perfection a particularly difficult opinion issue in these jurisdictions. Second, in many jurisdictions, including those within the Islamic economic sphere, and without regard to rahn concepts, perfection and priority regimes are not well developed. Third, bankruptcy laws and regimes are not well developed in these jurisdictions. To date, law firms have found it impossible to render satisfactory opinions on the priority and perfection in most of these jurisdictions.

## 6.8. Enforceability of Documents

Ratings criteria require that enforceability opinions be rendered on all transactional documents. As discussed in Section 5, the form of such an opinion is that the transaction documents are valid and binding obligations of the relevant entities, enforceable against such entities in accordance with their respective terms. The nature of the exceptions and qualifications to enforceability opinions in New York are set forth in Exhibit A. Those exceptions and qualifications are acceptable within the ratings criteria.

To date, legal opinions in jurisdictions within the Islamic economic sphere have included a number of other, much broader, exceptions and qualifications. These relate to the following:

(a) The Shari'ah is comprised of general principles, rather than specific legal requirements, and, as such, it is difficult to ascertain how the Shari'ah will be applied in any specific transaction.<sup>66</sup>

- (b) Different schools of Islamic jurisprudence interpret relevant Shari'ah principles and precepts differently, and inconsistently, resulting in similar uncertainties as to application in any given transaction.
- The lack of uniform statements of relevant Shari'ah principles and precepts.<sup>67</sup>
- (d) The lack of binding precedents and published decisions, further exacerbating uncertainties as to application of even agreed-upon Shari'ah principles and precepts.
- (e) The great degree of discretion in a court in these jurisdictions.
- (f) The uncertainty of remedies within these jurisdictions.
- (g) The fact that many of these jurisdictions will not enforce foreign judgments and, even where they will enforce foreign arbitral awards, may infuse the Shari'ah into a review of that award pursuant to public policy doctrines. 68

To date, the rating agencies and the lawyers who have been asked to provide enforceability opinions have been of the opinion that there is insufficient predictability and certainty to permit the rendering of sufficient enforceability opinions in these jurisdictions.

### 6.9. Choice of Law

Choice of law opinions are also required in connection with the ratings review. <sup>69</sup> The opinion must be to the effect that the choice of law will be upheld as valid by enforcing authorities in at least (a) the jurisdiction whose law has been chosen as governing the transactional documentation, (b) the jurisdiction(s) whose law governs the formation of each of the entities involved in the transaction, and (c) the jurisdiction in which the assets are located. These are complex legal opinions, and any analysis is beyond the scope of this chapter. It is sufficient to say, for present purposes, that the laws of many jurisdictions within the Islamic economic sphere are, at best, unclear as to choice of law principles. Thus, obtaining the choice of law opinions has been difficult, and in some cases impossible.

## 6.10. Enforceability of Judgments and Awards

Another requirement of the ratings criteria is legal opinions to the effect that the judgment of each court or arbitral authority of relevance to the transaction, which will include foreign courts and arbitral bodies, will be enforced in each of the jurisdictions involved in the

securitization transaction. As noted in the previous section, there are numerous involved jurisdictions, and they will vary from transaction to transaction. Some jurisdictions within the Islamic economic sphere will not enforce foreign judgments and arbitral awards. Some will enforce foreign arbitral awards, but not foreign judgments. In some jurisdictions, the extent and degree of enforcement of foreign judgments and awards is not entirely clear.<sup>70</sup>

Particular difficulties arise in connection with Shari'ah-compliant transactions. Consider, for example, enforcement of a foreign judgment or award that was rendered or obtained in a purely secular jurisdiction in a Shari'ah-incorporated jurisdiction, and vice versa. Will the judgment or award be reviewed de novo in whole or in part upon attempted enforcement in the Shari'ah-incorporated jurisdiction? Will a purely secular jurisdiction decline to enforce a judgment or award rendered in a Shari'ah-incorporated jurisdiction where the basis of the judgment or award is a Shari'ah interpretation of terms not included in the relevant contract? Will a court in a Shari'ah-incorporated jurisdiction infuse the Shari'ah into the foreign arbitral award as a matter of public policy, and pursuant to the public policy exception of the relevant treaties?

Lawyers are uncertain as to the answers to the foregoing, and many other similar queries pertaining to the enforceability of judgments and awards, and the exceptions and exclusions proposed in legal opinions have rendered those opinions insufficient for ratings criteria purposes.

#### 6.11. Observations

If Islamic finance is to move beyond the issuance of Islamic bonds and into the widespread issuance of securitization sukuk, with realization of attendant macroeconomic and microeconomic benefits, it is imperative that the issuances be rated by major international rating agencies. Obtaining those ratings will turn on the availability of legal opinions on the various matters discussed in this section. Acceptable legal opinions from major law firms are not currently available due to the lack of transparency, certainty and predictability of legal parameters in jurisdictions included within the Islamic economic sphere. Initiatives should be, and are being, undertaken to examine critical legal parameters, such as the bankruptcy laws of these jurisdictions and the ability to utilize trust structures (particularly in civil code jurisdictions). The Islamic Financial Services Board is taking a lead in this area. Real

progress, however, requires the effectuation of systemic legal reform in these jurisdictions, which will not be easily achieved. The composition of the IFSB is ideal for projects of this type as it includes as members a broad range of jurisdictions in which the uncertainties are particularly acute.

### 7. SUMMARY AND CONCLUSION

This chapter has reviewed some examples of the interaction between law (both the Shari'ah and secular law) and Islamic finance. It is clear that Islamic finance has had a profound effect on Islamic jurisprudence, facilitating the movement from a period of revival and recovery, commencing in the 1970s, to an innovative period of transformation and adaptation that commenced approximately a decade ago. The ability to use the nominate contracts, and hybrids of the nominate contracts, as well as other factors that comprise the current period, will now further drive the development of Islamic finance, particularly the development of a broader and more sophisticated range of products. Another key factor in the current period is the involvement of both conventional Western institutions and Shari'ah-compliant institutions in the developing Islamic economic sphere. This trend should result in a logarithmic increase in creativity and sophistication. More importantly, it should also result in enhanced understanding among the peoples of the world and a greater sensitivity to cultural, religious, social, and legal differences.

It is also clear that enforcement of the Shari'ah in both the Islamic economic sphere and the Western economic sphere, and in both Shari'ah-incorporated jurisdictions and purely secular jurisdictions, will be a matter of increased focus and relevance. An examination of the case law in a purely secular jurisdiction (Shamil Bank v Beximco) and of legal opinion practice indicates that the Shari'ah can be enforced in all relevant spheres and jurisdictions if (a) the relevant contracts used in the Shari'ah-compliant transaction are documented in such a manner as to be compliant with the Shari'ah (so as to enable enforcement under applicable secular law without any reference to the Shari'ah, whether as a governing law or otherwise), and (b) in other situations, model acts of relevant Shari'ah instruments, contracts, and structures are developed so as to allow sufficient specificity for incorporation in English or New York law documents.

While these developments give cause for optimism, the law presents significant hurdles to the further growth of Islamic finance in areas

such as capital markets access. Realization of the benefits of securitization, macroeconomic and microeconomic, in the field of Islamic finance will depend in part upon obtaining ratings of sukuk issuances. Obtaining these ratings depends, in turn, upon obtaining acceptable legal opinions on a range of true sale, collateral security, bankruptcy, and other legal issues. It is clear that the requisite opinions cannot be obtained at the current time given the state of development of these legal areas in many jurisdictions within the Islamic economic sphere. A call for action and legal reform is in order. Hopefully, involved organizations (such as the IFSB and AAOIFI), governments, regulators, financial institutions, lawyers, accountants, and market participants will undertake a study of necessary modifications to these legal regimes and effect necessary reforms to enable the rendering of the legal opinions that will allow for an explosion in the issuance of rated sukuk transactions.

Much has been accomplished in the fields of Islamic finance and the jurisprudence of the Shari'ah, and in many areas the secular law is conducive to the continuing growth of Islamic finance. But these successes should not deflect attention from the tasks that lie ahead, in particular the reform of secular law in jurisdictions within the Islamic economic sphere in order to bring Islamic finance to the next level of development and sophistication and to allow explosive growth in the Islamic economy. Let us not shrink from this endeavor, as the game, the benefits within the field of Islamic finance, and throughout both the Islamic economic sphere and the Western economic sphere, will certainly be worth the candle.

#### Exhibit A

Form of Enforceability Opinion: Shari'ah-Compliant Ijarah-based Acquisition Financing in a Purely Secular Jurisdiction

[Date]

[Name and Address of Financing Agent]

Re: [Name of Shari'ah-compliant Acquisition Financing Transaction]

Ladies and Gentlemen:

We have acted as special New York counsel to [name of the "Project Company"], a [limited liability company] organized under

the laws of the State of [Delaware], United States of America (the "Company"), in connection with the lease transaction evidenced by the documents listed in Schedule A hereto (the "Documents"),

This opinion letter is being delivered in connection with the execution and delivery of the Documents.

We have participated in the preparation, execution and delivery of the Documents. In rendering the opinion expressed herein, we have examined the Documents. In addition, to the extent relevant to our opinion expressed herein, we have examined the originals, or copies certified to our satisfaction, or electronic copies, of such other company records, certificates, resolutions, certificates of public officials and of directors, officers and other representatives of the Company, and agreements, documents and instruments, as we have deemed necessary as a basis for the opinion expressed herein. As to questions of fact material to such opinion, we have, when relevant facts were not independently established by us, relied upon certificates, representations and warranties of the Company and the other parties to the Documents or of their directors, officers or other representatives or of public officials and assumed the truth and accuracy of all such certificates, representations and warranties.

In our examination of the Documents, we have assumed, without independent investigation, and with your permission:

- the due execution and delivery of each Document by each of the parties thereto (other than with respect to the Company);
- (ii) the legal capacity of all natural persons;
- the due authority of all persons and entities signing each of the Documents and all related agreements, documents and instruments (other than with respect to the Company);
- (iv) the genuineness of all signatures;
- (v) the authenticity of the originals of all agreements, documents and instruments (including certificates) submitted to us;
- (vi) the conformity to originals of all agreements, documents and instruments (including certificates) submitted to us as copies;
- (vii) that each party to a Document (other than the Company), and each person or entity controlling or directing the acts, omissions, decisions and determinations of a party to a Document (other than the Company), including the

Facility Agent, will at all times act in good faith and in a commercially reasonable manner in the administration and enforcement of the Documents, all related agreements, documents and instruments, and the transactions contemplated by the Documents and such agreements, documents and instruments;

- other than with respect to the Company, each of the parties to the Documents has been and will continue to be, and was at the time of execution, delivery and performance of the Documents, duly formed, and is and will continue to be, and was at the time of execution, delivery and performance of the Documents, validly existing and in good standing under the law of the jurisdiction of its formation, and is and will be, and was at the time of execution, delivery and performance of the Documents, in good standing under the laws of the jurisdiction of its formation and each jurisdiction in which the Documents were or will be executed. delivered and performed, and has and will have, and had at the time of execution, delivery and performance thereof, full power and authority to execute, deliver and perform the Documents to which it is or will be a party (including all appropriate corporate, [limited liability company], regulatory and other approvals, including those permitting participation in the transactions contemplated by the Documents in accordance with their respective terms and to hold title to property in accordance therewith);
  - (ix) other than with respect to the Company, the execution, delivery and performance by each of the parties to the Documents have been duly authorized by all necessary action and have not, do not and will not (1) contravene the constituent or constitutive documents of such party or (2) require any governmental or regulatory authorization or other action under, any applicable law, rule or regulation;
  - (x) no consent, approval, authorization, order, registration or qualification of or with any court or other regulatory authority or governmental agency or body is required for the consummation of the transactions contemplated to be taken by the Company or any other party to any Document pursuant to the Documents under the laws of any jurisdiction (other than, with respect to the Company,

Government Approvals included within the Applicable Law of the State of New York, United States of America (the "State of New York") and the federal Applicable Law of the United States of America);

- (xi) the execution, delivery and performance by each of the parties to the Documents of the Documents will not violate any requirement of law (other than, with respect to the Company, Applicable Law upon which we opine herein);
- (xii) that the Documents are the legal, valid, and binding obligations of each of the parties thereto (other than the Company), enforceable against such parties in accordance with their respective terms, and that such Documents have mutuality of binding effect;
- (xiii) that the Facility Agent is a corporation duly organized and validly existing under the laws of the State of [Delaware], United States of America, and is qualified, to the extent qualification is necessary, and authorized to do business in the State of New York and the State of [name of State of transaction], United States of America; and
  - (xiv) that the provisions of the Lease (Ijara) (as defined in Schedule A) which may be governed by the laws of a State of the United States other than the State of New York, if any, constitute the legal, valid, binding, and enforceable obligations of the parties thereto in accordance with the laws of such other State or States, and insofar as the laws of such other State or States may be applicable to any matters opined upon herein, such laws are identical to the laws of the State of New York.

As used in this opinion letter, the phrases "to our knowledge" and "known to us" mean the actual knowledge (that is, the conscious awareness of fact or other information) of lawyers in the firm who have given substantive legal attention to representation of the Company in connection with the Documents. In addition, except to the extent expressly set forth in this opinion letter, we have not undertaken any independent investigation to determine the existence or absence of the matter in question, and no inference as to our knowledge of such existence or absence should be drawn from our representation of the Company.

We express no opinion as to the laws of any jurisdiction other than Applicable Law.

"Applicable Law" means those laws, rules and regulations of the State of New York and the federal laws of the United States of America currently in effect which in our experience are normally applicable to transactions of the type contemplated by any of the Documents, and does not include, and we express no opinion as to: (a) any New York or federal law, or any other law, relating to (i) title to any property (including the Property, as defined in the Lease (liara)), (ii) liens pursuant to any mortgage, deed of trust or security agreement or other security interests of any type, or the creation, validity, perfection or priority thereof, (iii) pollution or protection of the environment, (iv) zoning, land use, building or construction, (v) the construction, condition or use of such Property, (vi) labor, employee rights and benefits, or occupational safety and heath, or (vii) utility regulation; (b) antitrust laws; (c) tax laws, rules or regulations; (d) state, federal and other securities laws, including the Investment Company Act of 1940, as amended, and "blue sky" laws; or (e) any law, statute, ordinance, administrative decision, rule, regulation, ordinance, code or similar provision of law of any county, city, town, municipality or similar political subdivision or any agency or instrumentality thereof, "Government Approvals" means an order, consent, approval, license, authorization, or validation of, or filing, recording or registration with, or exemption by, any New York state court or federal court of the United States of America located in the State of New York, or any governmental body or authority in the State of New York or the United States of America, pursuant to Applicable Law.

Based upon the foregoing and subject to the limitations, qualifications, exceptions and assumptions set forth herein, we are of the opinion that:

- Each of the Documents constitutes the valid and binding obligation of the Company [enforceable] [capable of enforcement] against the Company in accordance with its terms.
- Each of the Documents is in proper legal form under Applicable Law, and is capable of enforcement in the State of New York. To ensure the validity and enforceability of the Documents, it is not necessary to register, record, file or notarize any of the Documents with any court or other government authority under Applicable Law.
- None of the execution and delivery by the Company of, or the performance by the Company in accordance with the terms

of, any Document violates or will violate any Law that is applicable to the Company.

- 4. No Government Approvals are required to be obtained under Applicable Law by the Company in connection with the execution and delivery by the Company of, and the performance by the Company in accordance with the respective terms of, any of the Documents to render the Documents valid and binding obligations of the Company enforceable against the Company in accordance with their respective terms.
- All required stamp duties, registration fees, filing costs and other charges, payable under Applicable Law in connection with the execution and delivery of any Document have been paid in full or an appropriate exemption therefrom has been obtained.

Our opinion is also subject to the following qualifications:

- The enforceability of the obligations of the Company under (a) the Documents is subject, in each case, to (i) the effect of any applicable bankruptcy, insolvency, reorganization, moratorium or similar law affecting creditors' rights generally (including, without limitation, laws relating to fraudulent transfers, conveyances, preferences and obligations). (ii) the effect of general principles of equity, including, without limitation, the availability of specific performance or other equitable remedies, and concepts of materiality, reasonableness, good faith and fair dealing (regardless of whether considered in a proceeding in equity or at law), and (iii) applicable laws, rules and regulations that limit the enforceability of provisions releasing, exculpating or exempting a party from, or requiring indemnification of a party for, liability for its own action or inaction in circumstances involving such party's negligence, bad faith or similar conduct.
- (b) The opinion set forth in paragraphs 1, 2 and 5 is qualified by the requirements of United States federal law and the law of the State of New York requiring registration, filing, recordation or filing, conditions and actions, and duties, fees, costs and other charges in connection with the commencement and continuation of legal and enforcement proceedings generally and those in the course of proceedings appropriate to

the introduction of agreements, documents and instruments generally.

We express no opinion herein as to:

- the enforceability of provisions purporting to grant to a party conclusive rights of determination;
- (B) the enforceability of rights to indemnification and contribution under federal or state securities laws, rules and regulations and other circumstances in which the enforceability of such rights may be limited by public policy;
- (C) the enforceability of waivers by parties of their respective rights and remedies under law;
- (D) the enforceability of any provision purporting to be or constituting an agreement to agree;
- (E) the enforceability of any provision purporting to require or requiring the performance of any obligation in contravention of any law, rule, regulation, injunction or other legal requirement that may be in effect at the time such performance is required;
- (F) except as expressly set forth in this opinion letter, the effect of the law, rule or regulation of any jurisdiction other than the State of New York wherein any party or property may be located or wherein enforcement of any Document may be sought, including any such law, rule or regulation that limits the rates of interest legally chargeable or collectible and any law, rule or regulation pertaining to intellectual property rights in any such jurisdiction;
- (G) the enforceability of any provision relating to the submission to the jurisdiction of any court where such court does not otherwise have appropriate subject matter jurisdiction over the relevant matter;
- the enforceability of any provision relating to set-off or to application of any deposit, property or indebtedness;
  - any provision of any Document providing for payments in the nature of liquidated damages except to the extent such payments are reasonable and do not constitute penalties;
  - (J) the effect on the opinion expressed herein of (1) the compliance or non-compliance of any party (other than the Company) to any of the Documents, or any person or entity other than the Company, with any state, federal, foreign or

other laws, rules or regulations applicable to it or (2) the legal or regulatory status or the nature of the business of any such party, person or entity;

- (K) the enforceability of any provision of any Document to the extent such provision provides for the performance by the Company of provisions contained in any other Document or any other agreement, document or instrument that is governed by any law other than Applicable Law;
- (L) any waiver of rights to assert the applicability of forum non-conveniens doctrines or similar doctrines limiting the availability of the courts of the State of New York as a forum for the resolution of disputes, in each case that are contained in the Documents (and we call to your attention that courts of the State of New York and United States of America federal courts sitting in the State of New York could decline to hear a case on grounds of forum non-conveniens or any such other doctrine);
- (M) the validity, creation, perfection or priority of, or any other matter in respect of, any security interest in any collateral purported to be granted by the Documents or any other agreement, document or instrument;
- (N) the enforceability of any provision of any Document that requires the Company to perform its covenants and agreements to operate its business in any specified manner that is contrary to Applicable Law; and
- (O) the availability of equitable remedies.

Our opinion in paragraph 1 as it pertains to the choice of law provision in each Document is rendered in reliance upon the Act of July 19, 1984, ch. 421 McKinney's Sess. Law of N.Y. 1406 (codified at N.Y. Gen. Oblig. Law 5-1401, 5-1402 (McKinney 2001) and N.Y. CPLR 327(b) (McKinney) (the "Act"), and is subject to the qualifications that such enforceability (1) may be limited by public policy considerations of any jurisdiction, other than the courts of the State of New York, in which enforcement of such provisions, or a judgment upon an agreement containing such provisions, is sought, and (2) as specified in the Act, does not apply to the extent provided to the contrary in subsection two of Section 1-105 of the New York Uniform Commercial Code (McKinney 1993 & Supp. 2001).

This opinion letter is being furnished only to you in connection with the transactions contemplated by the Documents and is solely for your benefit and is not to be used, circulated, quoted, published, relied upon or otherwise referred to by any other person or entity or for any other purpose or in any other connection without our prior written consent. This opinion letter is given on and as of the date hereof, and we assume no obligation to advise you after the date hereof of facts or circumstances that come to our attention, or changes in laws, rules or regulations that occur, after the date of this opinion letter which could affect the opinion contained herein.

Very truly yours,

#### SCHEDULE A

- (a) the Finance Lease (*Ijara*) and Purchase Option Agreement, dated as of [date], 20,, between [name of the Funding Company], a corporation incorporated under the laws of the State of [Delaware], United States of America (the "Funding Company") and the Company (the "Lease (*Ijara*)");
- (b) the Understanding to Purchase, dated as of [date], 20, between the Funding Company and the Company;
- (c) the Understanding to Sell, dated as of [date], 20, between the Funding Company and the Company;
- (d) the Property Transfer Price and Basic Rent Note, dated as of [date], 20\_, from the Company and issued to the Funding Company; and
- (e) the Managing Contractor Agreement, dated as of [date], 20, between the Funding Company and the Company.

#### **ENDNOTES**

- <sup>1</sup> This badith was related in nearly all of the major collections, including those of al-Bukhari, Muslim, Abu Daud, al-Tirmidhi, al-Nasa'i, Ahmad ibn Hanbal, Ibn al-Jarud, al-Tabarani, and Ibn Abi Shayhab.
- <sup>2</sup> Bernard Weiss, The Spirit of Islamic Law (1992), p. 18. Note the substitution of "commitment" for Weiss's "submission."
- There is also the fact that for several centuries the contribution of the Ottoman Empire in the development of Islamic finance was quite limited.
- The Mit Ghamr project in Egypt in 1963, the Nassar Social Bank in Egypt, the Organization of the Islamic Conference (formed in 1971), the multinational Islamic Development Bank (formed in 1975), and the Dubai Islamic Bank were early examples. See Nicholas Dylan Ray, Arab Islamic Banking and the Renewal of Islamic Law (1995) ("Ray, Islamic Law"); and see Abdullah Saeed, Islamic Banking and Interest (1996), pp. 5–16, for a more detailed discussion of some of the early events in the development of Islamic banking and finance.

- While the rate of growth of deposits and assets in the first 15 years was described as astounding, a study of this early period points to the "lack of profitable investment opportunities," citing the reliance of the Islamic banks on projects and inventory finance. Ray, Islamic Law, p. 21.
- <sup>6</sup> Dr. Muhammad Adb al-Ghatfar al-Sharif, "The Shariah Supervision of Islamic Banks," paper presented at the First Conference of Shari ah Supervisory Boards for Islamic Financial Institutions, organized by the Auditing and Accounting Organization for Islamic Financial Institutions (AAOIFI) in Bahrain, October 2001.
- Muhammad Zahid al-Kawthari, Fiqh Abl al-Traq wa Hadithuhum (1970), pp. 56–59.
- 8 W.D. Slawson, Binding Promises (1996), pp. 9-19.
- This is the well-known work entitled Maialat al-Abkam al-Adaliyab, originally prepared by Ottoman scholars of the Hanafi school of jurisprudence for use throughout the courts of the Ottoman Empire circa 1839/1285 A.H. This work was translated into the English language by an accomplished British jurist and scholar of Arabic, Judge C.A. Hooper, and was published in 1936. Long out of print, the work was again published, in installments, by the Arab Law Quarterly in 1986.
- The stories of how the early jurists, such as Abu Hanifa, Malik, Shafii, and Ibn Han-bal, resisted the efforts of the temporal authorities to codify their legal thought, and to impose those codes throughout their empires, are well known in Islamic history.
- Many Orientalists, even those as recent as Schacht, went as far as to question the relationship of theory in Islamic financial transactions to historical practice. Recent inquiry has put such negativity to rest. In fact, the success of modern Islamic finance is probably the best of all arguments against such assertions. See Ray, Islamic Lane, pp. 35–36.
- The meaning of this term, derived from the same root as bibad, is the expending of the utmost effort in the exercise of legal scholarship in order to interpret the law, fiqb.
- <sup>13</sup> Peter L. Bernstein, Against the Gods: The Remarkable Story of Risk (1996), p. 205. In the passage quoted, Bernstein is summarizing the explanation developed by Kenneth Arrow and Frank Hahn of the relationship between money, contracts, and uncertainty.
- Nelly Hanna, Making Big Money in 1600: The Life and Times of Ismail Abu Taqiyya, Egyptian Merchant, Syracuse University Press, New York, 1998, p. 54.
- 25 "... one fact is certain, the legal instruments necessary for the extensive use of mercantile credit were already available in the earliest Islamic period." Abraham Udovitch, "Credit as a Means of Investment in Medieval Islamic Trade," 10 Princeton Near East Papers 1 (1969).
- 16 The authors refer here to criticism made by Orientalist scholarship.
- 17 Hanna (1998), p. 59.
- <sup>18</sup> In this regard, it will be helpful to note the origins of the derivatives used in modern conventional finance. "In fact, the majority of financial instruments are not revolutionary new instruments. They are merely combinations of older generation derivatives and/or standard cash market instruments." Warren Edwardes, Key Financial Instruments: Understanding & Innovating in the World of Derivatives (2000), p. 8.

- While this has become commonplace today, it is interesting to note a reference in the first encyclopedia of Islamic banking, published in 1982, in which a description of a modem murababah is based on a personal conversation with an officer of an Islamic bank. See al-Mausu at al-Ibrityah wall-Amaliyah li'l-Banuk al-Islamiyah, al-Ittibad al-Duwali li'l-Bunuk al-Islamiyah, Cairo, 1982, Vol. V, p. 196.
- <sup>20</sup> In fact, there are two promises inherent to this transaction; the promise of the client to buy from the bank, and the promise of the bank to sell to the client. The entire matter became the subject of much discussion by the scholars at the First Conference of Islamic Banks in Dubai in 1979. Their collective fatausa approving this arrangement was a significant milestone in the jurisprudence of modern Islamic finance.
- <sup>21</sup> For a look at more examples, see Abdulkader Thomas, Stella Cox, and Bryan Kraty, Structuring Islamic Finance Transactions (2005) and the sources cited at footnotes 25 and 27.
- Mausu at al-Bunuk al-Islamiyah, al-Ittihad al-Duwali li al-Bunuk al-Islamiyah (1983). Several of the authors and contributors to that early work are still contributing to the development of the industry with their hard work, devotion, and invaluable experience.
- 23 For example, as Islamic investors move into the real estate markets of Asia and the European Union, asset managers, legal counsel, and Shari'ah scholars are challenged with documentation in several different languages, sometimes for a single transaction!
- <sup>24</sup> Brief descriptions of how all three of these nominates have been adapted to form the basis of different home financing programmes may be found in Abdulkader S. Thomas and Virginia B. Morris, Guide to Understanding Islamic Home Finance (2002).
- 25 See Nathif J. Adam and Abdulkader Thomas (eds.), Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk (2004), Micheal J.T. McMillen, "Islamic capital markets: Developments and Issues", Capital Markets Lue Journal (2006; Oxford University), 10, 1093/cmlj/km/015, and Michael J.T. McMillen and Abradat Kamalpour "An Innovation in Financing Islamic CMBS" in Commercial/Mortgage Backed Securitization: Developments in the European Market (2006, "Commercial CMBS" at pp. 382–412). The meterial in Section 6.1 is addressed in detail in Commercial CMBS.
- 26 These, of course, are the texts of the Qur'an and the Sunnah.
- See Michael J.T. McMillen, "Islamic Shari'ab-compliant Project Finance: Collateral Security and Financing Structure Case Studies," 24 Fordbam International Law Journal 1184, pp. 1237–63, describing the first such transactions in the United States ("McMillen, "Project Finance Structures"). See, also, Michael J.T. McMillen, "Islamic Shari'ab-compliant Project Finance: Collateral Security and Financing Structure Case Studies," The Proceedings of the Third Harward University Forum on Islamic Finance: Local Challenges, Global Opportunities, pp. 111–31 (2000). Modifications of this type of structure and their use in various transactions is discussed in Michael J.T. McMillen, "Shari'a-compliant Finance Structures and the Development of an Islamic Economy," The Proceedings of the Fifth Harvard University Forum on Islamic Fonance: Islamic Finance: Dynamics and Development, pp. 89–102 (2003). Other illustrative developments are discussed in Michael J.T. McMillen, "Islamic Finance Review 2005/2006: A Year of

- While the rate of growth of deposits and assets in the first 15 years was described as astounding, a study of this early period points to the "fack of profitable investment opportunities," citing the reliance of the Islamic banks on projects and inventory finance. Ray, Islamic Law, p. 21.
- Or. Muhammad Adb al-Ghaffar al-Sharil, "The Shariah Supervision of Islamic Banks," paper presented at the First Conference of Shari'ah Supervisory Boards for Islamic Financial Institutions, organized by the Auditing and Accounting Organization for Islamic Financial Institutions (AAOIFI) in Bahrain, October 2001.
- Muhammad Zahid al-Kawthari, Fiqh Abl al-Traq wa Hadithuhum (1970), pp. 56–59.
- 8 W.D. Slawson, Binding Promises (1996), pp. 9-19.
- This is the well-known work entitled Majalat al-Ahkam al-Adaliyah, originally prepared by Ottoman scholars of the Hanafi school of jurisprudence for use throughout the courts of the Ottoman Empire circa 1839/1285 A.H. This work was translated into the English language by an accomplished British jurist and scholar of Arabic, Judge C.A. Hooper, and was published in 1936. Long out of print, the work was again published, in installments, by the Arab Law Quarterly in 1986.
- The stories of how the early jurists, such as Abu Hanifa, Malik, Shafii, and Ibn Hanbal, resisted the efforts of the temporal authorities to codify their legal thought, and to impose those codes throughout their empires, are well known in Islamic history.
- Many Orientalists, even those as recent as Schacht, went as far as to question the relationship of theory in Islamic financial transactions to historical practice. Recent inquiry has put such negativity to rest. In fact, the success of modern Islamic finance is probably the best of all arguments against such assertions. See Ray, Islamic Law, pp. 35–36.
- The meaning of this term, derived from the same root as hihad, is the expending of the utmost effort in the exercise of legal scholarship in order to interpret the law, figh.
- 13 Peter L. Bernstein, Against the Gods: The Remarkable Story of Risk (1996), p. 205. In the passage quoted, Bernstein is summarizing the explanation developed by Kenneth Arrow and Frank Hahn of the relationship between money, contracts, and uncertainty.
- <sup>14</sup> Nelly Hanna, Making Big Money in 1600: The Life and Times of Ismail Abu Taqiyya, Egyptian Merchant, Syracuse University Press, New York, 1998, p. 54.
- 15 .... one fact is certain, the legal instruments necessary for the extensive use of mercantile credit were already available in the earliest Islamic period." Abraham Udovitch, "Credit as a Means of Investment in Medieval Islamic Trade," 10 Princeton Near East Papers 1 (1969).
- 16 The authors refer here to criticism made by Orientalist scholarship.
- 17 Hanna (1998), p. 59.
- <sup>18</sup> In this regard, it will be helpful to note the origins of the derivatives used in modern conventional finance. "In fact, the majority of financial instruments are not revolutionary new instruments. They are merely combinations of older generation derivatives and/or standard cash market instruments." Warren Edwardes, Key Financial Instruments: Understanding & Innovating in the World of Derivatives (2000), p. 8.

- While this has become commonplace today, it is interesting to note a reference in the first encyclopedia of Islamic banking, published in 1982, in which a description of a modem murabahah is based on a personal conversation with an officer of an Islamic bank. See al-Mausu at al-Ilmiyah wa'l-'Amaliyah li'l-Bumuk al-Islamiyah, al-Ittibad al-Duwali li'l-Bunuk al-Islamiyah, Cairo, 1982, Vol. V, p. 196.
- <sup>20</sup> In fact, there are two promises inherent to this transaction; the promise of the client to buy from the bank, and the promise of the bank to sell to the client. The entire matter became the subject of much discussion by the scholars at the First Conference of Islamic Banks in Dubai in 1979. Their collective [atawa approving this arrangement was a significant milestone in the jurisprudence of modern Islamic finance.
- <sup>21</sup> For a look at more examples, see Abdulkader Thomas, Stella Cox, and Bryan Kraty, Structuring Islamic Finance Transactions (2005) and the sources cited at footnotes 25 and 27.
- Mausu at al-Bunuk al-Islamiyah, al-Istihad al-Duwali li al-Bunuk al-Islamiyah (1983). Several of the authors and contributors to that early work are still contributing to the development of the industry with their hard work, devotion, and invaluable experience.
- 23 For example, as Islamic investors move into the real estate markets of Asia and the European Union, asset managers, legal counsel, and Shari'ah scholars are challenged with documentation in several different languages, sometimes for a single transaction!
- <sup>24</sup> Brief descriptions of how all three of these nominates have been adapted to form the basis of different home financing programmes may be found in Abdulkader S. Thomas and Virginia B. Morris, Guide to Understanding Islamic Home Finance (2002).
- 25 See Nathif J. Adam and Abdulkader Thomas (eds.), Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk (2004), Micheal J.T. McMillen, "Islamic capital markets: Developments and Issues", Capital Markets Law Journal (2006; Oxford University), 10, 1093/cmly/km/015, and Michael J.T. McMillen and Abradat Kamalpour "An Innovation in Financing Islamic CMBS" in Commercial/Mortgage Backed Securitization: Developments in the European Market (2006, "Commercial CMBS" at pp. 382–412). The meterial in Section 6.1 is addressed in detail in Commercial CMBS.
- 26 These, of course, are the texts of the Qur'an and the Sunnah.
- See Michael J.T. McMillen, "Islamic Shari'ah-compliant Project Finance: Collateral Security and Financing Structure Case Studies," 24 Fordham International Law Journal 1184, pp. 1237–63, describing the first such transactions in the United States ("McMillen, "Project Finance Structures"). See, also, Michael J.T. McMillen, "Islamic Shari'ah-compliant Project Finance: Collateral Security and Financing Structure Case Studies," The Proceedings of the Third Harward University Forum on Islamic Finance: Local Challenges, Global Opportunities, pp. 111–31 (2000). Modifications of this type of structure and their use in various transactions is discussed in Michael J.T. McMillen, "Shari'a-compliant Finance Structures and the Development of an Islamic Economy," The Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development, pp. 89–102 (2003). Other illustrative developments are discussed in Michael J.T. McMillen, "Islamic Finance Review 2005/2006: A Year of

Globalization and Integration," and Michael J.T. McMillen, "Raising the Game of Compliance: People and Organizations," each in Euromoney Islamic Finance Year in Review 2005/2006 (2006). Other transactions are discussed in Michael J.T. McMillen, "Structuring the Shari'ah-compliant Transaction Involving Non-compliant Elements," paper currently in publication by Euromoney as a chapter in a forthcoming book, and in Michael J.T. McMillen, "Structuring Shari'ah-compliant Transactions Involving Non-compliant Elements: Use of the Nominate Contracts," a paper presented at the Islamic Financial Services Board conference, Islamic Financial Services Industry and the Global Regulatory Environment Summit 2004, May 18–19, 2004, in London.

<sup>28</sup> See, for example, McMillen, "Project Finance Structures," pp. 1237–63. These early transactions were described in the press: Michael J.T. McMillen, "Special Report U.S. Briefing: Islamic Finance: Breaking the Mould," 38 Middle Fast Economic Digest (MEED), September 22, 2000, pp. 28–29.

There is widespread, and spirited, debate regarding the "need" for standardization in the Islamic finance field. This is certainly not a new debate for Muslim jurisprudents: witness the intellectual rigor of the debate over the centuries among Islamic jurists of even the four main schools of Sunni Islam: the Hanafi, Hanbali, Shafi'l, and Maliki schools. Recent English-language works that highlight this debate, by way of a comparison of the positions of the different schools of Islamic jurisprudence with respect to specific matters, are Frank E. Vogel and Samuel L. Hayes, III, Islamic Law and Finance: Religion, Risk and Return (1998), and Financial Transactions in Islamic Jurisprudence, Dr. Wabban Al-Zubayli's Al-Figh Al-Islami wa 'Adillatuh (Islamic Jurisprudence and its Proofs), translated by Mahmoud A. El-Gammal (2003), which is a translation of Volume 5 of Al-Figh Al-Islami wa 'Adillatub, fourth edition (1997) and appears in two volumes. For examples of the current debate with respect to the need for standardization on a broader scale within the Islamic finance industry one need only attend any of the many Islamic finance conferences. See, also, Majid Dawood, "Scholastic Congestion," Islamic Banking and Finance, Issue 3, pp. 10-11.

For a review of the extent to which, and the manner in which, the laws of various Middle Eastern nations are comprised of, or incorporate, the Shari'ah, and the extent to which other legal principles are incorporated in the laws of such nations, see Nayla Comair-Obeid, The Law of Business Contracts in the Arab Middle East (1996), particularly Chapter 3. The discussion in this section, to the extent that it addresses the integration of the Shari'ah into the law of the various nations, is based in part upon this secondary source. See Noel J. Coulson, Commercial Law in the Gulf States (1984). See, also, Noel J. Coulson, A History of Islamic Law (1964) and Joseph Schacht, An Introduction to Islamic Law (1964), as general histories of Islamic law.

31 The Kingdom of Saudi Arabia recognizes the Shari'ah as the paramount law of the land. However, the various enforcement mechanisms that have been established with respect to the resolution of certain commercial disputes do influence the application of the Shari'ah to such disputes. One example is the settlement of disputes between a bank and its customer in Saudi Arabia. The "settlement" of such matters (other than in respect of negotiable instruments) is effected by the Banking Disputes Settlement Committee of the Saudi Arabian Monetary Agency (customarily known as the SAMA Committee), and the SAMA Committee generally attempts to settle a

matter in accordance with the agreement of the parties. Another example in Saudi Arabia is indicated by the jurisdictional authority afforded to the Office of the Settlement of Negotiable Instruments Disputes (NIO), under the aegis of the Ministry of Commerce, which addresses and settles disputes involving negotiable instruments and generally looks only to the "four corners" of the instrument to which the dispute relates. See McMillen, "Project Finance Structures," pp. 1195–203.

- 32 For the purposes of this chapter, the distinctions between the various Shari'ahincorporated jurisdictions are ignored unless otherwise indicated.
- 33 Assuming, of course, that the contract does not violate public policy or fall foul of other mandatory legal requirements.
- 34 See, for example, some of the incorporation and choice of law requirements that are discussed or referred to in Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco, as discussed in Section 4 of this chapter.
- 35 Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco Pharmaceuticals Ltd. and Others [2004] EWCA Civ 19, [2004] All ER (D) 280 (Jan), January 28, 2004.
- 36 Shamil Bank v Beximco, at para. 7, quoting clauses 35 and 36 of the Articles of Association of Shamil Bank.
- 37 Shamil Bank v Beximco, at para. 46, quoting Lord Wilberforce in Reardon Smith Line Ltd v Yngvar Hansen-Tangen [1976] WLR 989 at 996.
- 38 Shamil Bank v Beximco, at para, 47,
- 39 Shamil Bank v Beximco, at paras 40 (relating to the lower court decision) and 42 and 43 (noting that the Beximco Companies accept the principle of a single governing law based upon the Rome Convention). The Rome Convention has the force of law in the United Kingdom by virtue of section 2(1) of the Contracts (Applicable Law) Act of 1990, as stated in para. 40 of Shamil Bank v Beximco.
- 40 Shamil Bank v Beximco, at para, 48, citing Article 3.1 of the Rome Convention ("a contract shall be governed by the law chosen by the parties"). Paragraph 40 summarizes the similar finding of the lower court.
- 41 Shamil Bank v Beximco, at para. 48, citing Article 1.1 of the Rome Convention ("the rules of this Convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries"). Paragraphs 40, 42, and 43 summarize the lower court's similar finding on this issue of interpretation.
- 42 Shamil Bank v Beximco, at para. 48.
- 43 Shamil Bank v Beximco, at para. 54. See, also, Shamil Bank v Beximco at para. 40 with respect to the characterization of this matter by the lower court.
- 44 Shamil Bank v Beximco, at para. 55. See, also, Shamil Bank v Beximco at para. 40 with respect to the characterization of this matter by the lower court.
- Shamil Bank v Beximco, at paras 50–52, citing Dicey & Morris, The Conflict of Laws, thirteenth edition, Vol. 2, at 32–086 and 32–087.
- 6 Shamil Bank v Beximco, at para. 51.
- 47 Shamil Bank v Beximco, at para. 52.
- The United States is comprised of 50 separate States (including four Commonwealths and a Plantation), a non-State Commonwealth, various Territories, and a federal government, each having a separate and distinct legal system and set of substantive laws. Conflicts of laws issues are thus a daily matter of significant import and consequence in contractual matters in the United States or involving the law of any of the component jurisdictions of the United States. This governmental structure is one of the factors that led to the creation of the National Conference

of Commissioners on Uniform State Laws in 1892, with a primary purpose of obtaining a degree of uniformity in the laws of the various states, thus enhancing commerce between and among the States and the certainty and predictability of legal enforcement in different state jurisdictions. Neither the National Conference of Commissioners on Uniform State Laws nor the federal government has the power or authority to prescribe uniform laws among the States; adoption of such laws is a matter of state discretion and prerogative. The success that has been achieved by the National Conference of Commissioners on Uniform State Laws in achieving a degree of uniformity, and in providing methods of defining and tracking differences where there is not uniformity, is an important basis for a proposal previously made by Mr. McMillen to the effect that "model laws" be prepared for each of the main contracts used in Islamic finance. See Michael I.T. McMillen, "Enforceable in Accordance with Its Terms': A Proposal Pertaining to Islamic Shari'ah," Fourth Meeting of the Council and Second Meeting of the General Assembly of the Islamic Financial Services Board, Bali, Indonesia, 2 Raby' al-awal 1425 H.E., April 2, 2004 C.E. ("McMillen, 'IFSB Shari'ah Enforceability Proposal"). The Government of Canada, which is comprised of 13 Provinces and Territories and a federal government, and the European Union, among others, grapple with similar, if less extensive and frequent, conflicts of laws issues.

49 See, for example, McMillen, "Project Finance Structures," pp. 199 et seq. and sources cited therein.

McMillen, "IFSB Shari'ah Enforceability Program," addresses issues relating to legal opinions in Shari'ah-incorporated jurisdictions as well as those provided in purely secular jurisdictions. Discussions of the former have been omitted from this paper.

53 "Third Party 'Closing' Opinions: A Report of the TriBar Opinion Committee," 53 Business Lauver 592 (1998), p. 619. This report is referred to in this paper as the "TriBar Report." See, also, "Special Report by the TriBar Opinion Committee: Use of the ABA Legal Opinion Accord in Specialized Financing Transactions," 47 Business Lauver 1720 (1992), which is referred to as the "TriBar Specialized Financing Report." And see "Third-Party Legal Opinion Report, including the Legal Opinion Accord, of the Section of Business Lau, American Bar Association," 47 Business Lauver 167 (1991) at Section 10, "The Remedies Opinion," and the definition of "Remedies Opinion" in the Glossary thereof.

The TriBar Report notes that all undertakings in the agreements with respect to which the enforceability opinion relates are covered by the opinion. TriBar Report, p. 621. The TriBar Report, at footnote 69, notes that coverage of all undertakings is based upon New York custom and practice, and that not all jurisdictions so interpret opinions. The variance noted in such footnote 69 is that of the "1989 Report of the Committee on Corporations of the Business Law Section of the State of California Regarding Legal Opinions in Business Transactions," 45 Business Lawyer 2169 (1990). That report endorses a narrower definition of the scope of the enforceability opinion, limiting the coverage of the opinion to only "material" provisions of the agreements that are the subject of the enforceability opinion. It is important to be familiar with the scope of the enforceability opinion in the governing law jurisdiction.

53 See the relevant opinion language in Exhibit A.

54 TriBar Report, p. 620.

- 55 TriBar Report, p. 620.
- <sup>66</sup> TriBar Report, p. 621. Note that a "representation" in a contract is not an "undertaking."
- <sup>67</sup> TriBar Report, p. 621. If the remedy is one that a court in the governing law jurisdiction will not enforce, the opinion will, and must, make an exception for the enforcement of that remedy.
- 58 TriBar Report, p. 621.
- 59 See the TriBar Specialized Financing Report,
- 60 TriBar Specialized Financing Report, p. 1726.
- This chapter does not consider the important topic of the regulation of capital markets activities, such as securities issuance, standards applicable to investment companies, capital adequacy standards, prudential standards, trading activities, brokerage activities, and market manipulation regulations. See Commercial CMBS for a discussion of these topics.
- Other areas of the legal infrastructure are not considered in this chapter, largely because of the tremendous diversity over different jurisdictions. These areas include tax law, real estate law, competition law, and corporate law, among many other areas of applicable law.
- 63 Entity organization opinions are critical, and are obtained, but are not discussed in this chapter. These opinions address formation of relevant entities, due authorization of the transaction by all entities, and due execution and delivery of all documentation.
- In addition to bankruptcy remoteness provisions discussed in the text of this chapter, there are also requirements for provisions limiting recourse for payments and indemnities to only the securitized assets (and applicable credit enhancements), provisions mandating that the priority of payments set forth in the documents shall govern in all cases, and provisions to the effect that, after full realization on all securitized assets (and credit enhancements), all payment and indemnity claims are extinguished. These provisions are not further discussed.
- 65 And this is not specific to Shari'ah-compliant transactions.
- 66 Consider, for example, Section 4 and the Shamil Bank v Beximco case discussed in that section with respect to exceptions noted in clauses (a) through (c).
- 67 See McMillen, "IFSB Shari'ah Enforceability Proposal."
- 68 See the discussion of enforcement of foreign judgments and awards at McMillen, "Project Finance Structures," pp. 1199-203, and the sources cited therein.
- 69 Consider the discussion at Section 4 and the Shamil Bank v Beximco case discussed in that section.
- <sup>70</sup> See McMillen, "Project Finance Structures," pp. 1195–203, and the sources cited therein, for a discussion of enforcement mechanisms in the Kingdom of Saudi Arabia.

# Supervisory Implications of Islamic Finance in the Current Regulatory Environment

Hari Bhambra

#### 1. INTRODUCTION

The strength of a financial industry is based on the confidence investors have in it. One of the main factors contributing to confidence in a financial center is its regulatory system, which seeks to promote that very confidence. Islamic finance needs to ensure that its customers have confidence in it to ensure that this fledgling industry can continue to grow and remain a permanent part of the global financial system.

As discussed in earlier chapters, Islamic finance raises a number of unique risks. These risks have regulatory ramifications. This chapter seeks to address the fundamental question of how, if at all, these issues can be addressed within the current regulatory environment.

Globalization of finance, and the rapid integration of Islamic finance into mainstream finance, raise a number of challenges for regulators across the world.

The supervisory implications of regulating Islamic finance have two facets: first, regulation in a wholly Islamic jurisdiction; and second, regulation of both Islamic finance and conventional finance. This chapter will focus on the second facet, the supervisory implications of regulating both Islamic and conventional finance. This opens two further questions: (a) whether a single regulator can regulate both conventional and Islamic finance; and (b) the rather different question of whether it is possible for a single integrated regulatory approach or regime to apply to both conventional and Islamic finance.

Perhaps one of the greatest challenges faced by regulators is that of aligning the international standards adopted across the global financial system with the fragmented standards and practices that have emerged across the Islamic financial services industry which has until recently been working as a niche industry, somewhat detached from mainstream finance.

Similarly, regulators of Islamic finance in wholly Islamic financial systems face their own share of concerns to ensure that Islamic financial institutions remain sound and stable, particularly as such institutions may have limited risk management capabilities.

Some critics argue that Islamic finance cannot be fully understood within a conventional financial system that is based on the mechanism of interest, a mechanism that violates the very essence of Islamic finance.1 The purpose of this chapter is to assess the reality of this view

#### 2. THE ROLE OF A REGULATOR

Financial services regulation can be a political and cultural balancing act.2 It often involves reconciliation of the competing goals of providing a sufficient degree of flexibility to facilitate innovation while setting rules stringent enough to deter financial misconduct.

A regulator will develop a regulatory regime that reflects not only its political and legal environment but also its own regulatory objectives. For example, in jurisdictions where customer protection is a regulatory objective, tools such as customer education and greater disclosure will be prevalent. The regulatory balance is achieved through the creation of the appropriate operating environment within the confines of the legal and political system concerned.

Commonly, regulatory frameworks evolve in response to serious financial failures; indeed, how a regulator deals with financial crises often adds to, rather than detracts from, its credibility. The ability of a market (and the regulator concerned) to survive a serious financial failure depends upon the depth and maturity of the market concerned. The more mature the market, the stronger is its ability to sustain serious financial failures. A fledgling financial services industry, such as Islamic finance, may not currently have sufficient depth and maturity to be able to withstand financial failures; such a failure could seriously

damage confidence in both the industry and the relevant regulatory authority.

Financial services regulators, cognizant of the fact that the industry is constantly evolving, need to have in place tangible regulatory measurements in order to provide the necessary degree of certainty and the relevant parameters within which financial centers can operate. Seeking to provide tangible regulatory measurements across an industry that is based on Shari'ah interpretations and rulings that may lack consistency is a hurdle for many regulators of Islamic finance.

Regulators should therefore draw upon the experiences of their own and other financial centers to find the most appropriate regulatory environment for Islamic finance. Clearly, drawing upon the experiences of global financial centers that are based on conventional, riba, finance will require due consideration and adaptation to reflect the unique characteristics of Islamic finance, but at least the foundations for regulation of Islamic finance can be laid.

Islamic finance is a mode of financing based on Shari'ah. It is primarily an asset-backed, contract-based financing system, which, although devised for Muslim customers to ensure that they can have Shari'ah-compliant, riba-free financing, is available to customers of all faiths. Islamic finance also has as one of its core principles the sanctity of contractual relationships, including fiduciary relationships of profit-and loss-sharing, or profit-sharing and loss-bearing, a between the customer and the institution.

In conventional finance, customers earn interest on their deposits, which represents a liability for the institution concerned. In Islamic finance, customers seeking returns from their monies can open profit-sharing investment accounts (PSIAs) by entering into a mudarabah contract with the institution concerned. Under the mudarabah, the customer<sup>4</sup> provides the capital for investment to the institution in its capacity as mudarib.<sup>5</sup> The underlying investment activity will generate the profit (or loss), which will be distributed between the mudarib and the customer according to pre-determined profit-sharing ratios (see note 3).

Theoretically, Islamic finance, particularly mudarabah, should pose a lower level of risk to the participating institutions, as financial losses are borne either in whole or in part by the customer (although commercial reality does diverge to some extent from the theory, as discussed later in this chapter).

While Islamic finance has traditionally been a mode of financial intermediation providing financing solutions for customers, it is now expanding into mainstream finance such as capital markets with, interalia, the issuance of sukuk. Its rapid growth has posed interesting challenges to the industry and regulators alike.

#### 3. THE REGULATORY POSITION IN RELATION TO SHARI'AH

Shari'ah oversight is an integral part of Islamic finance, ensuring that the financial products and services offered by Islamic firms are indeed Shari'ah-compliant. Shari'ah oversight is usually provided in the form of a committee or board of Shari'ah scholars. These Shari'ah committees/boards raise a number of issues for the industry and regulators.

First, across the Islamic financial services industry there are a limited number of Shari'ah scholars who are sufficiently versed in both Shari'ah and finance, resulting in a highly concentrated pool of scholars sitting on a number of committees/boards of Islamic firms. This raises regulatory concerns of conflicts of interest. Many jurisdictions set out to mitigate, as far as possible, this inherent risk with strong systems and controls requirements, and guidelines on the appointment process of Shari'ah scholars. However, the industry is in need of more Shari'ah scholars, not just to mitigate issues of conflicts of interest, but also to accelerate the industry's growth, which, arguably, may become stifled due to the limited availability of Shari'ah scholars. Innovation in financial markets is very rapid, and Islamic firms, as with conventional firms, need to be able to respond to the needs of the market in a timely manner or face competitive disadvantages. This issue is particularly pronounced in Islamic firms where, for instance, the Shari'ah approval process may delay the introduction of new products or services to the market.

However, there are certainly aspects of regulation, or codes, which can be and have been extended to the Shari'ah committee/board, such as personal account dealing; but again, in those jurisdictions where this has been the case, the responsibility rests with the Islamic firm itself to ensure that such codes are complied with by the Shari'ah committee/board.

Second, the roles and responsibilities of Shari'ah committees/boards will vary across firms and jurisdictions. A clear understanding of the role and influence that a Shari'ah committee/board has on the business of an Islamic firm is a matter for careful consideration by a regulator. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has provided some guidance on the composition and role of a Shari'ah committee/board of an Islamic firm, which is a welcome move to bring consistency in this area, but in the absence of mandatory implementation of such standards across the Islamic financial services industry the roles and responsibilities of Shari'ah committees/boards will continue to vary. Some regulators have sought to address this issue through the implementation of AAOIFI's Governance Standards.6 In some jurisdictions, these standards have been supplemented by clear demarcation of the roles of the Shari'ah committee/board and senior management of the Islamic firm. For example, the Dubai Financial Services Authority (DFSA)7 places sole responsibility for the operation and ensuring daily compliance with regulatory requirements, including Shari'ah systems requirements (discussed below), with senior management of the firm, and the role of the Shari'ah committee/board is regarded as advisory only. In addition, the Islamic Financial Services Board (IFSB) has issued an exposure draft (ED3) on the corporate governance of Islamic financial institutions that addresses governance issues relating to Shari'ah compliance, as well as other aspects of the corporate governance of Islamic financial institutions.

Third, what regulatory responsibility, if any, do such Shari'ah committees/boards carry, bearing in mind the significance of their role? As discussed above, the key role of a Shari'ah committee/board is to provide Shari'ah advice and approval.8 AAOIFI's Governance Standards indicate that the Shari'ah committee/board should perform a review of the Islamic firm to ensure that the firm has acted in compliance with Shari'ah.9 Were the Shari'ah committee/board. for example, not to undertake such a review, would a regulator have the requisite powers or regulatory tools to take action? This issue is clearly complicated and, of course, sensitive, but as AAOIFI's GSIFI No. 2 indicates, the ultimate responsibility will rest with senior management of the institution to ensure that the firm has been operating in compliance with Shari'ah. Many regulators across the world have chosen to adopt the position of evaluating institutions' internal systems and controls for ensuring Shari'ah compliance, with responsibility for the establishment and functioning of such systems resting firmly with the regulated firm. Such regulators do not seek to regulate Shari'ah compliance directly (see Section 4.4 below)

#### 4. THE REGULATORY CHALLENGE: ADDRESSING THE UNIQUE RISKS IN ISLAMIC FINANCE

Effective risk management requires effective risk measurement, and for this regulators must understand the products, contracts, and services offered by Islamic firms.

A common supervisory approach for both Islamic and conventional firms is indeed possible where the supervisory regime focuses on risk. Islamic finance is subject to some of the same risks as conventional finance, including market and credit risk. In certain structures, Islamic firms are also (albeit indirectly) affected by interest rate movements. most notably in mark-up structures; therefore, regulators have to take a realistic view of the actual risks to which Islamic firms are exposed in order to provide the most appropriate regulatory and prudential framework.

### 4.1. Shari'ah-compliant Risk Mitigation

In devising the most appropriate regime, particularly a prudential one, regulators need also to recognize that although the same risks may apply in both types of institutions, the same risk mitigants are not always available to Islamic firms. Even basic penalty clauses10 against defaulting debtors may not be permissible in Islamic finance, whereas they are commonplace in conventional banks.

The limited availability of Shari'ah-compliant risk mitigation techniques and risk mitigation instruments to Islamic firms may impede risk management in those firms, resulting in identified but unaddressed risks.

### 4.2. Legal and Prudential Risks

Legal risks can also have prudential and Shari'ah implications, depending upon when legal title transfers from the firm to the customer. Taking a murabahah contract as an example, where the purchase and resale of the underlying asset is effected instantaneously, questions of Shari'ah compliance may arise. 11 Prudential risks may also arise in circumstances where the customer is not bound to, or chooses not to, take possession of the underlying assets, resulting in the firm being left with unwanted, depreciating assets. 12 Clearly, these Islamic structures need to be understood by both the firms themselves as well as the regulators, to identify what risks arise and at what stage, in order to determine the type of exposure and how best to mitigate it.

Profit-sharing investment accounts also pose prudential risks. PSIAs give rise to two unique risks. Fiduciary risk arises under a mudarabah contract where there is loss caused by the misconduct or negligence of the mudarib; the consequences are that a PSIA that would otherwise be akin to equity becomes a liability, thus raising prudential implications.

The second unique risk is displaced commercial risk (DCR), which is where Islamic theory gives way to commercial practice. According to theory, under a PSIA the customer and the institution share the profits of the underlying investment (losses being borne by the customer13) according to the principle of mudarabah. However, in practice, the profit- and loss-sharing principle gives way to the actual practice of "smoothing" the returns to customers for commercial reasons, exposing Islamic firms to DCR,14 where the institution as mudarib forgoes part or all of its share of profits and passes these to the customer, commonly to match the investment yields15 offered by competitors in the market. The consequence of such "smoothing" is that a prudential regulator is left with the uncertainty of trying to establish a regulatory framework for a product that is not treated consistently or according to theory across the industry. In an attempt to provide a degree of regulatory certainty, the guidelines issued by the AAOIFI with the implementation of a DCR charge provide one solution and indeed have been adopted by a few regulators in an attempt to cushion this risk. A more sophisticated approach to dealing with DCR from a capital adequacy standpoint was developed by the IFSB in its standard on capital adequacy (IFSB, 2006).

#### 4.3. Product Definition

It can sometimes be difficult for regulators to provide the most suitable regulatory framework where they are unable to define the products and risks associated with Islamic finance. Even though the risks that arise are common to both Islamic and conventional firms, the risks may manifest themselves at different stages of a transaction. These stages should be understood and accounted for appropriately by a regulator.

### 4.4. Shari'ah Non-compliance Risk

Shari'ah is the cornerstone of Islamic financial products and services. If customers became aware that the products they have in their

portfolio were not Shari'ah-compliant, this would seriously undermine customer confidence in the Islamic firm concerned or, on a larger scale, in the Islamic financial services industry as a whole,

Shari'ah non-compliance risk is clearly a major challenge for regulators. Shari'ah non-compliance could in extreme cases have systemic implications. Some regulators have sought to find a solution 16 through the implementation of adequate systems and controls that ensure compliance with Shari'ah ("Shari'ah systems and controls," for ease of reference). Such Shari'ab systems and controls should ensure that the rulings and fatawa of the Shari'ah Supervisory Board (SSB) are disseminated and implemented throughout the firm. These systems may also be supplemented with internal and external Shari'ah compliance requirements, as promulgated by the AAOIFI. These systems and controls requirements provide a mechanism for a regulator to monitor, control, and take action against a firm if it does not meet Shari'ah requirements based on a failure to maintain and comply with its internal systems and controls without the need for the regulator to regulate Shari'ah. Such Shari'ah systems and controls provide tangible measurement against which a regulator can perform its function.

Every regulatory structure needs to have adequate enforcement powers to ensure that the necessary action can be taken in the event of a violation of regulatory laws or regulations.

When examined in the context of Islamic finance, issues of enforcement can become sensitive, particularly where there has been a failure by a firm to meet a Shari'ah ruling issued in respect of its products or services. This raises the fundamental question of what role a regulator is to play in respect of such issues in Islamic finance.

It is not desirable or within the remit of a financial services regulator to opine on questions of Shari'ah. 17 The most desirable outcome is that the regulator's remit be confined to the regulation of financial services.

#### 5. WINDOWS OPERATIONS

Perhaps one of the unresolved challenges in Islamic finance is finding the most consistent regulatory framework for Islamic windows. The move toward consistency would be helped if there were a recognized definition. Islamic windows come in many forms, ranging from small Shari'ab units within conventional firms to large-scale branches that offer all forms of banking services parallel to those products and services offered by the conventional firm within which they sit. 18

Apart from the criticisms and perception that an Islamic window cannot truly be Shari'ah-compliant, a more fundamental regulatory problem arises when assessing the extent to which segregation of the conventional and Islamic business can be achieved to ensure that the Islamic window is not operating in a manner that would violate Shari'ah.

The regulator concerned needs to consider these issues, which, if left unaddressed, may result in Islamic windows, in the jurisdiction concerned, facing difficulties in building and maintaining credibility as a provider of Shari'ah-compliant finance.

The AAOIFI has provided some direction on the approach to Islamic windows, primarily in relation to segregation of accounts, Shari'ah requirements, and specific disclosures.

Some regulators have sought to expand on the requirements suggested by the AAOIFI by applying Shari'ah systems and controls and full Shari'ah oversight requirements<sup>19</sup> to Islamic windows.

#### 6. IS INTEGRATION OF REGULATORY REQUIREMENTS FOR ISLAMIC FINANCE AND CONVENTIONAL FINANCE POSSIBLE?

Having identified the issues and risks arising from Islamic finance, the next step is to determine what degree of integration of regulatory standards is possible, and whether such integration is an appropriate step for regulators to take when devising the regulations for the supervision of Islamic firms.

Often, a regulator that adopts an integrated approach to regulating both industries may be criticized for discriminating against Islamic firms by imposing conventional standards on Islamic finance without adequate consideration of the unique risks and issues that arise.

Perhaps it is more a matter of semantics than discrimination. A regulatory framework which imposes the same systems and controls, conduct of business, and disclosure and prudential requirements across conventional and Islamic firms may be seen as imposing conventional standards without due consideration for Islamic finance. However, if there is modification within such standards, then it is clearly possible to unify and integrate regulation as some regulators around the world have already chosen to do. Some regulators may refer to such modification as a segregation of regulatory requirements, while others will refer to it as part of an overall integrated regulatory

regime, resulting in the same regulatory approach being applicable. addressing the same risks and perhaps in the same manner, but semantics may cause one regulatory approach to be perceived to provide segregated regulatory requirements.

There are clearly circumstances where certain international standards and codes are capable of application to both Islamic firms and conventional firms, such as fitness and properness, and personal account dealing standards that can apply both to individuals within firms and also be extended to those Shari'ah scholars who are appointed by Islamic firms. Needless to say, there are, of course, areas where internationally recognized standards do require modification in order to reflect the specificities of Islamic finance, but the critical issue is to understand when such a modification is required rather than modifying for the sake of it. To have a separate regime for Islamic finance, as in some jurisdictions, may only serve to duplicate common areas of regulation and lead to an increase in the costs of regulation, which in turn may not make such markets competitive. In this spirit, the IFSB has developed standards on capital adequacy and risk management for Islamic financial institutions that build on existing authoritative pronouncements intended for conventional financial institutions and adapt or complement these where necessary for application in Islamic finance.

Taking the Dubai Financial Services Authority20 as an example, it does indeed apply the same requirements across both industry sectors, but it has made additional changes and modifications in a number of areas within its overall integrated framework to reflect and accommodate the specificities of Islamic finance.

Some core elements of regulation are capable of extension to Islamic firms, such as systems and controls and disclosure requirements. In respect of regulatory systems and controls requirements, all regulated firms should have strong systems and controls in place to manage their business and the associated risks. Additionally, for Islamic firms, the systems and controls should have defined the internal Shari'ah systems, which provide an invaluable regulatory tool to at least quantify the extent of Shari'ah compliance prevalent within the firm without the need to assess finite points of Shari'ah. From a regulatory perspective, deviations from Shari'ah rulings become matters of systems and controls breaches, not religious matters.

In respect of disclosure obligations, all firms, including Islamic firms, must provide regulatory and transaction data to their customers at appropriate intervals. Islamic firms should also provide enhanced disclosure for specific Islamic contracts to ensure that customers understand the products as well as the risks involved. For example, specific disclosure requirements for PSIAs should be in place to ensure that customers clearly understand the profit- and loss-sharing obligations under the relevant Islamic contract.<sup>21</sup>

In an attempt to address some of the risks unique to Islamic firms, regulators have in some jurisdictions sought to modify regulatory requirements to address the specific risk profiles of certain Islamic contracts – for example, PSIAs. In the context of PSIAs, displaced commercial risk, as discussed earlier in depth in this chapter, can be addressed by applying the DCR charge promulgated by the AAOIFI or the more developed approach in the IFSB Standard. In respect of fiduciary risk, additional systems and controls can be imposed on the individual mudarib that is responsible for the day-to-day management of the PSIA monies, and standards of fitness and propriety should be equally applicable to this individual as one would expect to see applied to investment managers in conventional finance. The mudarib's conduct should also fall within the scope of any regulatory reviews or risk assessments, to at least ensure that the mudarib has operated within the objectives set by the customer.

Finally, with PSIAs, enhanced disclosure, or in certain jurisdictions that lack transparency, basic transaction and regulatory data - that is, "periodic statements" - ought to be provided to account holders both at the outset of the relationship and on an interim basis, providing relevant information in respect of the account. The provision of relevant, timely data will enable customers to make informed decisions in respect of the financial products and services being offered to them, and may facilitate an alignment of practice and standards across the industry - for example, a customer who at the outset of the relationship is well informed about the risks and obligations arising under a PSIA, and periodically informed about the investment performance, may serve to mitigate the extent to which the Islamic firm as mudarib is exposed to DCR.22 In this context, the IFSB is developing a standard on transparency and market discipline consistent with Pillar 2 of the New Capital Accord (Basel II) but adapted to the specificities of Islamic finance.

As discussed above, in respect of Shari'ah non-compliance risk, the implementation of Shari'ah systems and controls provides a tangible regulatory solution to an otherwise politically and religiously sensitive regulatory problem. Further guidance on the regulatory review process

for Islamic financial institutions, consistent with Pillar 2 of Basel II, is being developed in the form of a standard by the IFSB.

In light of the above, it is possible for integrated regulatory standards and regulatory frameworks and concepts, albeit with due modifications, to apply to both industries.

Some specialized guidance for the Islamic financial services industry that does not exist in the international standards of, inter alia, the Basel Committee on Banking Supervision (BCBS)23 and International Organization of Securities Commissions (IOSCO) is being provided by the useful work of both AAOIFI and now the IFSB.

#### 7. CONCLUSION

Islamic finance is becoming part of mainstream finance; as such, in order to optimize this position, the greater the consistency and standardization of regulations, the greater will be the opportunity to compete in the global financial system. Unification of standards is becoming increasingly important with the onset of Basel II. Islamic firms, as well as conventional firms, can use this opportunity to overhaul internal practices, particularly risk measurement and management capabilities.

As this chapter has discussed, it is possible, and desirable, for a conventional regulator equipped with adequate regulatory tools (disclosure, regulatory and prudential reporting, policy development capability, powers to inspect and investigate, combined with adequate powers of enforcement) to provide an integrated regulatory structure, with justified modifications to reflect the specificities of Islamic finance, to apply across the industry and create a level regulatory platform. It is therefore not a question of whether the regulator is a conventional regulator, or is regulating a purely Islamic market. The issue is the ability of the regulator to identify, understand, and have the regulatory powers and inclination to address the specificities of Islamic finance. The mission of the IFSB is to provide standards and guidelines to assist regulators and the Islamic financial institutions under their authority to do precisely this.

As finance and regulation becomes more global, standardization of financial techniques and financial services regulation is not only encouraged at the international arena, but is desirable in the interests of fairness and competitiveness. Creating a level playing field in the form of consistent regulation is necessary for the functioning of an open financial market. To have unwarranted differentiation in regulatory standards could adversely affect the Islamic financial services industry.

Islamic financial institutions and regulators of Islamic finance are working with the IFSB and other agencies to make the necessary adjustments to international standards in order to reflect the needs and risks of the Islamic financial services industry. The starting point for making change at an international level is to implement the existing standards (as far as possible) at a domestic level. Islamic firms and practitioners should welcome the application of international standards to their business, rather than see it as an imposition of inapplicable conventional standards.

Islamic finance is firmly a feature of mainstream finance. It must be supported, and support itself, to ensure that it retains its foothold in the industry.

#### **ENDNOTES**

- Islamic finance accepts that capital has a cost or time-value, but in order to be entitled to a return it must be "materialized" in the form of an asset, asset services, or a business venture. This is sometimes referred to as the materiality requirement. Capital in the form of money is not entitled to any return, as this would be interest (riba).
- In the context of Islamic finance, regulators may also have to balance the religious aspect of Islamic finance, which has implications for the ways in which, or indeed as to whether, particular financial transactions (including those for risk management purposes such as hedging) may be carried out. Political and cultural issues are more pronounced in those regions where Islamic finance has its foundations. Moreover, most of the countries where Islamic financial institutions are located are emerging market countries. Implementing international regulatory standards in such regions will need to be a gradual process.
- <sup>3</sup> In a mudarabah contract (see below) the Islamic bank and the customer share in profits from the investment, but only the customer bears losses (unless the Islamic bank has been guilty of misconduct or negligence). The bank suffers an "opportunity loss" in respect of its time and efforts.
- 4 The customer is referred to as rabb ul maal, meaning "provider of capital."
- 5 Mudarib is broadly translated to mean account/fund manager.
- <sup>6</sup> Bahrain Monetary Agency (BMA) and the Dubai Financial Services Authority (DFSA).
- <sup>7</sup> DFSA is the independent regulatory body for the Dubai International Financial Centre (DIFC), a financial free zone in the emirate of Dubai.
- Other additional roles may be requested of such Shari'ah committees/boards in certain jurisdictions.
- 9 AAOIFPs GSIFI (Governance Standard for Islamic Financial Institutions) No. 2,
- Nome institutions are permitted to charge a penalty clause but then donate the proceeds to charity.

- Such as the case where title to the asset is not actually transferred to the Islamic bank, but passes directly from the supplier to the customer (supposedly acting as agent for the bank in acquiring the asset, but in fact acting as principal), who thus receives a conventional (non-Shari'ah-compliant) credit facility rather than a murababab.
- 12 It is possible to apply the underlying asset as collateral to mitigate the relevant
- 13 The customer as rabb ul maal.
- 14 Further alternatives to addressing the issue of smoothing are being developed. Some academics, notably V. Sundararajan, have suggested a value-at-risk model as a more accurate measure for displaced commercial risk.
- Some comparisons may also be made with interest rate levels offered by conventional banks.
- 16 Dubai Financial Services Authority, the independent regulator for the DIFC.
- 17 Some jurisdictions and some regulators have a centralized Shari'ah board to whom such matters of Shari'ah disputes or breaches can be referred.
- 18 HSBC Amanah is provided as an example of a windows operation that offers full banking and capital markets services parallel to those services offered by the conventional parent, HSBC.
- 19 "Shari'ah oversight requirements" in this context is a reference to the Shari'ah report and review to be undertaken annually by Islamic firms as prescribed by AAOIFI's Governance Standards.
- DFSA, although it applies an integrated regime, has a separate Law Regulating Islamic Financial Business, a specific Islamic Finance Module within the overall regulatory rulebook, and specific requirements for Islamic securities.
- 21 The DFSA has imposed this specific requirement in its Islamic Finance Module in relation to PSIAs.
- 22 A customer who better understands that the profit to be received can fluctuate or may not exist in certain periods should reduce the extent to which the firm feels under commercial pressure to "smooth" returns. Such disclosure and true alignment of PSIAs with Islamic theory would be tantamount to treating PSIAs as akin to funds rather than deposits, as they are treated in many jurisdictions.
- 22 Some recognition of the need to adapt international standards was made in 1999 through the work of the AAOIFI with the issuance of the Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks. This has now been followed by the IFSB's standard on capital adequacy.

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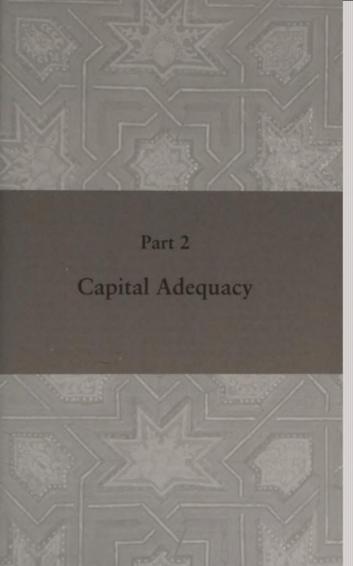
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# Risk and the Need for Capital

Charles Freeland and Steven Friedman

#### 1. INTRODUCTION

B ank supervisors regard capital as a key element in the regulatory framework. For institutions whose liquid assets are a small proportion of their liabilities, banks have traditionally needed to show a good margin of reserves in order to retain the confidence of their depositors and the public. This practice was codified in the 1998 Basel Capital Accord, and more recently in the 2004 Revised Capital Framework, promulgated by the Basel Committee on Banking Supervision. The 1998 Accord was justifiably regarded as a regulatory landmark and has had a profound influence on banking institutions around the world.

But what exactly is capital? In practice, it can be defined in various ways depending on the source of the question. For the public, and the bank depositor in particular, it represents the cushion available to absorb losses. For the accountant, it represents the surplus of assets over liabilities. For the bank, it represents its reserves and non-deposit liabilities, forming a distinction between internal and external capital. This is also largely how the supervisors see it, though supervisors may differentiate not so much between external and internal capital as between free reserves and equity on the one hand, and lesser-quality reserves and junior and senior debt on the other.

What is especially critical is that the measure of capital is only accurate if the assets (and liabilities) are on the balance sheet at their fair value. Since capital is only a relatively small part of a bank's balance sheet, it can evaporate rapidly if only a small proportion of the loans are impaired or turn out to be irrecoverable.

Historical perspective sheds some light on the evolution of capital regulation. Back in the 19th century, many banks had capital to assets ratios of 30% or more as a means of retaining customer confidence in an era of not infrequent bank runs. As government and central bank influence in the financial sector grew stronger, and in particular following the U.S. Depression and the development of federal deposit insurance, banks were able to leverage more and more on their capital. By the early 1980s, ratios had declined to perhaps 3% in several major banks, plainly inadequate to meet potential shocks in the system. At the same time, central banks were well aware that the fast rate of growth in interbank transactions, arising particularly from the dynamic derivatives markets, was making it increasingly difficult to envisage the failure of a major bank. What became known as "toobig-to-fail" represented a situation in which increasing risks were being run by major financial players, with the taxpaver shouldering the potential cost of a failure.

One of the core concepts of capital is that it represents the owners' wealth in the business, and their confidence in management's ability not only to protect but also to increase this stock of wealth. However, with increased wealth as a result of returns on capital, owners can become more risk-averse. Strong capital levels should therefore lead to more prudent behavior. This does not necessarily apply in equal measure to widely held joint-stock banks, but even small shareholders want to see their contribution to capital employed prudently and efficiently.

The market's perception that a bank is strongly capitalized offers it distinct competitive advantages by allowing it to negotiate more advantageous spreads. A capital cushion enables a bank to manage its business in a more flexible manner, by taking advantage of business opportunities, to manage its liquidity more aggressively, and to protect itself from possible predators. It also provides an additional attraction for its human talent, important in the increasingly competitive labor market.

The Basel capital ratio is based on a carefully defined numerator (the capital definition) and denominator (the measure of risk). The numerator of the equation, capital itself, is divided into a number of eligible components with different limits and sub-limits. The first tier of capital, largely shareholders' paid-up capital built up from retained profits, has to represent at least half of the total measure of capital.

The second tier of capital can be made up from other elements that add to the strength of the bank, such as revaluation reserves arising from unrealized book profits or upwards re-measurement of assets to fair value, general loan-loss provisions under certain conditions, and a sub-set of liabilities with characteristics of capital, such as hybrids of debt and equity instruments and subordinated term debt.

The denominator of the capital ratio represents the asset base. Under regulatory capital requirements, the assets are weighted according to broad categories of perceived risk. It is important to note that this includes off-balance-sheet as well as on-balance-sheet risks. Under the original Accord, the on-balance-sheet risk categories were deliberately broad – the Accord used a portfolio approach designed to estimate an appropriate measure of capital.

Before the original Capital Accord was negotiated, the definition of capital and the capital requirements across the G10 countries had significant differences. So far as the definition of capital was concerned, the differences arose from institutional features of the national banking systems and the manner in which they were financed – for example, some countries had developed equity markets with traditions of common share ownership; in some others the banking sector had been partly financed by cross-shareholdings with other financial institutions; still others had single strong shareholders.

# 2. THE EVOLUTION OF INTERNATIONAL CAPITAL STANDARDS

When the Basel Committee first began discussing capital adequacy seriously in the early 1980s, a global standard was far from its thoughts. The Committee began with a fact-finding survey, with the intention of comparing the arrangements in different markets and examining whether it might be possible to develop best practice guidelines.

A sequence of events triggered more focused efforts that eventually resulted in the 1988 Accord. The first was the work in the European Community on defining a common capital standard. Then, as the gravity of the Latin-American debt crisis of the early 1980s became clearer, many bank supervisors and other policy makers began to express the view that bank capital standards had been allowed to fall to a level that exposed the world's major banks to a systemic crisis.

Supervisors at the Federal Reserve and other U.S. institutions with banking oversight responsibilities were particularly strong voices for change, as they observed the significant burden of the Latin-American debt crisis on several large U.S. banks. The Bank of England also saw the gravity of the situation from the perspective of the world's largest financial center.

In response to these events, in the early 1980s US regulators attempted to introduce a tighter capital standard for U.S. banks. However, these efforts ran into strong opposition from the banking industry, which was concerned about possible negative effects of tighter capital standards on their international competitiveness. At the time, Japanese banks were expanding rapidly on the back of a strong domestic market and attempting to increase market share abroad. A number of high-profile takeovers, or takeover attempts, of U.S. banks by Japanese interests raised protectionist concerns. Policy makers in the U.S. and in other G10 countries concluded that the only way in which the capital levels of the world's principal banks could be raised was through a global agreement. In 1985, the G10 Governors therefore gave the Basel Committee a mandate to report to them on the modalities of achieving agreement among committee members on a minimum capital standard.

By 1987, the Committee had held a number of tightly focused meetings in which the main elements of the Capital Accord were put in place. In that year, committee members moved forward with an arrangement in the Accord that would divide capital into two tiers of different quality. By the fall, members reached agreement on an 8% risk-weighted capital ratio, 4% for each tier, and by December a consultative paper was ready for approval by the G10 Governors. It is important to understand that the level of 8% was not selected as a result of calculations of historical non-repayment for default risk, even though the 8% ratio was measured against credit risk alone. While somewhat of a judgment call by the supervisors who negotiated the 1988 agreement. the 8% ratio was not agreed upon without conducting a considerable amount of testing based on banks' existing capital mixes and balance sheets. In this way it was possible to make a fairly close assessment of the capital ratios of the banks in the G10 countries and to judge what ratio would represent an acceptable level of capital cover

# 3. THE MOVE TO MORE RISK-BASED APPROACHES

The Basel Committee never regarded the initial Capital Accord as a static measure of capital adequacy. Several times since 1988 changes were introduced, in respect of both the definition of capital (tightening up on the definition of general provisions within Tier 2 and redefining the eligibility of hybrid instruments within Tier 1), the risk weights and the treatment of netting. The most significant revision to the 1988 Accord was the market risk capital amendment of 1996, which allows certain risks such as foreign exchange, security, and commodity trades to be carved out of the credit risk measure and given a separate capital charge calculated according to the net uncovered position.

The simplicity of the 1988 Accord was one of its key strengths and one of the reasons for its broad acceptance at a time when international prudential standards in any industry were considered by many to be a novel, if not alarming, idea. But over time its very simplicity became one of its key drawbacks, as the Accord became a target for creative bankers to circumvent. In particular, the institutional approach to risk allocation provided an incentive to remove some high-quality assets that attracted high capital charges from the balance sheet. In the decade following the Accord's introduction, financial markets had become increasingly more complex, with the result that the Accord could no longer credibly assign capital charges in relation either to the risks of these products - such as securitized assets with different tranches of risk and derivatives products - or to the risk mitigation techniques commonly employed by banks. In addition, advances in technology and risk management practices had led to more sophisticated approaches to default and loss estimates, and spoke to the possibility of calibrating capital charges with greater granularity than the broad exposure classifications of the 1988 Accord.

While recognizing the need for a capital standard that could address these developments, the Committee realized that the standard would also have to remain appropriate for less sophisticated banks both in the developed industrialized world and in economies of the emerging markets that mainly undertake more traditional credit provision functions. This viewpoint influenced the decision to create supervisory options for capital calculations that could be scaled to the sophistication of jurisdictions' banking industries, and even to

the sophistication of categories of banks within a jurisdiction. This was clearly beyond the scope of simple amendments to the original Accord, and also argued in favor of an entirely new capital standard.

The limited scope of the 1988 Accord also weighed in the decision to rethink capital standards entirely, rather than add amendments to the original document. Specifically, the objective of the 1988 standard was to provide a general capital cushion against all risks, including market risk, operational risk, interest rate risk, and legal risk. However, the original capital ratio was expressed only in terms of credit risk, because that was historically the greatest risk for banks and the one that could be measured most simply through a broadly institutional approach. The market had in fact validated this iudement in its own manner - banks were not only expected by equity investors, creditors, and rating agencies to have capital ratios above 8%, but those that did not maintain a healthy margin above this level were not regarded as having the highest standing. In the ensuing years, however, the greater complexity of banking institutions and their growing involvement in non-credit activities spoke to the need to design a standard that would separately assess capital adequacy against different types of risk.

Committee members also recognized that while capital adequacy is a vital component of a banking institution's success and viability, the quality of management and of internal controls has consistently proven to be an equally critical element of success. Indeed, these elements can rightfully be viewed as a bank's first line of defense, since experienced management and robust controls can lessen the probability of significant losses that would eat into capital. Committee members thus sought appropriate ways to incentivize banks to continue improving their risk management practices. Clearly, this added goal broadened the scope of the capital framework well beyond that of the 1988 agreement, and further tilted the Committee's thinking toward an entirely new standard and away from a patchwork of amendments to the original Accord.

The new framework addresses the expanded goals of the Committee by introducing three mutually reinforcing "pillars." It is critical that all three pillars are implemented effectively, because the greater freedom provided by the adoption of a risk-based approach requires additional checks and balances.

The first pillar consists of minimum capital requirements; the second, the concept of supervisory review; and the third, market discipline. The first pillar seeks to align bank capital more closely with the actual risks that banks face, while presenting banks and their supervisors with options that allow the capital rules to be scaled to the level of sophistication. Thus, banks with a more traditional banking business will be able to readily apply more risk-sensitive capital charges using information technology and management practices that are compatible with the complexity of their operations. More sophisticated institutions, however, will be able directly to use aspects of their risk quantification and management techniques in regulatory capital calculations. This will result in capital charges that are more closely aligned with actual risk, and thus provide incentives for all banks to refine their risk measurement practices.

Another important feature of Pillar I is the adoption of a specific charge for operational risk. It is fair to say that the concept of operational risk is still relatively new and the approaches to measuring and managing it are still in a developmental stage, but it is a risk that is already significant and is plainly growing in importance as a direct result of the sheer complexity of modern finance. The intention to adopt a capital charge has given the industry a significant incentive to develop methodologies to address this complex risk.

The second pillar recognizes the responsibility of the supervisor to promote the overall safety and soundness of the banking system, while also stressing that individual banks have primary responsibility for managing their own risks. Pillar 2 stresses the critical role of dialogue between supervisors and banks, which can serve to provide additional incentives for banks to manage risk in a prudent fashion. Of equal importance under the second pillar, however, is that by establishing a set of common guidelines for supervisory review, supervisors around the world will implement the new Accord with greater consistency, thereby encouraging a more level playing field and decreasing the regulatory burden on banks operating in different jurisdictions.

The third pillar involves the market in the capital adequacy regime. The new Accord stipulates a number of minimum public reporting standards on risk and risk management. These will enhance the ability of market participants to understand each bank's risk profile and the sufficiency of its capital relative to its risk, and should enable competitors, analysts, rating agencies, and academics to exert the market discipline required to reinforce the relative freedom in the new Accord. Essentially, the more a bank uses internal methodologies to measure its risk capital, the greater the disclosure requirement will be.

# 4. WHAT CAN INTERNATIONAL CAPITAL STANDARDS ACHIEVE?

An important point to remember about the 1988 Basel Accord is that it was negotiated specifically as an agreement between Basel Committee countries, and thus was intended to apply only to "internationally active" banks in these countries. And while in theory the Basel Committee has no legal powers to enforce the Accord, in practice the public endorsement of the G10 Governors and the publicity surrounding the Accord have made it difficult for G10 countries to evade it. The process has been eagerly embraced by the credit rating agencies, which enthusiastically used the Accord as a means of comparing different banks. Expressed in different words, the delivery of a common measurement tool has provided additional market discipline in an industry for which systemic risk is an ever-present threat.

The original Basel Accord has had a significant influence on banks, supervisors, and investors around the world, initially in the G10 and OECD countries, but in recent years even more broadly, with well over 100 countries eventually adopting the original capital standard. The Accord has clearly led to the strengthening of capital standards among the world's banks, particularly the large, internationally active banks for which it was intended, and has also led to a more level playing field by ensuring against slides in prudential standards in any one country that could in turn lead to competitive imbalances.

#### **ENDNOTES**

<sup>&</sup>lt;sup>1</sup> In the Revised Capital Framework, general provisions up to a limit of 1.25% of risk-weighted assets can be included in Tier 2 capital under the standardized approach; under the internal ratings-based approach, only the portion of eligible provisions that exceeds expected losses can be included in Tier 2 capital, and only up to a maximum of 0.6% of credit risk-weighted assets.

<sup>&</sup>lt;sup>2</sup> See Chapter 11.



## Measuring Risk for Capital Adequacy: The Issue of Profit-sharing Investment Accounts

Simon Archer and Rifaat Ahmed Abdel Karim

#### 1. INTRODUCTION

This chapter is concerned with the rationales for the regulation of capital adequacy in the case of conventional banks, and their applicability to institutions offering Islamic financial services in the form of banking (hereafter, "Islamic banks"). Section 2 examines the rationales for capital adequacy of conventional banks. Section 3 analyzes the extent to which these rationales are applicable to Islamic banks, and examines the issues that arise in that context. Section 4 considers the links between capital adequacy and risk management in the context of the Basel Committee on Banking Supervision's Revised Framework (Basel Committee on Banking Supervision, 2004). Section 5 sets out some concluding remarks.

#### 2. WHY CAPITAL ADEQUACY?

All organizations that incur liabilities require some form of capital backing in order to support those liabilities – that is, for the purpose of creditor protection. In the non-profit or government sectors, this backing may be in the form of a guarantee. For commercial firms, market forces operate so that undercapitalized firms find it hard to obtain credit. In many jurisdictions (but not, for example, in the U.K.), commercial firms that are limited companies are also required by law to build up a "statutory reserve" out of retained profits for creditor

protection purposes, and are subject to dividend restraints until they have done so. Also, company law typically prevents limited companies from paying dividends out of capital and out of certain reserves (such as revaluation reserves) that are not formed out of retained profits. But outside of the financial sector, the matter of capital adequacy is left essentially to market forces; in other words, undercapitalized firms encounter difficulties in obtaining credit, and so on. In fact, the term "capital adequacy" is not normally used in connection with non-financial firms; instead, the more general term "solvency" is used to refer to the ability to service liabilities. In contrast, capital adequacy is seen as a major issue for financial sector firms, and its use implies that the matter is not essentially left to market forces as in the case of non-financial firms. Why is this? The literature on capital adequacy gives the rationales for its regulation as follows:

- a. Financial sector firms, and especially banks and insurance companies, are subject to various forms of regulation that impede the normal operation of market forces. In the case of banks, such regulation has as a major objective the mitigation of the systemic risk of contagious collapse, whereby one firm's failure triggers a series of others, thus imposing social costs. Banks are particularly vulnerable to contagious collapse because of the liquid nature of their liabilities combined with the illiquid nature of their assets and the magnitude of financial distress costs. But the default of an investment firm may also impose social costs, especially if it is part of a bank (in a universal banking regime) so that the bank's capital stands behind its investment operations (Dale, 1996).
- b. Regulation may include a deposit guarantee system, which reduces incentives for depositors to impose market discipline on banks with regard to their risk taking. This leads to the deposits being underpriced in terms of their interest rates, and provides incentives for banks to hold less capital than would otherwise be required by market forces to support the risks to which they expose their depositors' funds, or alternatively to take on more deposits than is justified by their capital base (a moral hazard problem).

For these reasons, capital adequacy has long been a preoccupation of banking supervisors. The Basel Committee on Banking Supervision (BCBS), part of the Bank for International Settlements, issued its first Capital Accord ("Basel I") in 1988. The Capital Accord was based on a two-pronged approach to capital adequacy. The first prong was a measure of risk in terms of risk weightings applied to assets, the only risk to be considered being credit risk. The second prong was a measure of the regulatory capital available to support the risk, divided into Tier 1 and Tier 2 capital. (A Tier 3 was subsequently introduced in the 1996 Amendment to the Capital Accord to Incorporate Market Risks.) As well as equity capital, regulatory capital included amounts classified as general provisions and also (subject to limitations) subordinated debt. The latter is widely used by banks in some countries (especially the U.S.) where its pricing plays a role in market discipline. The ratio of regulatory capital to the amount of risk-weighted assets is the capital adequacy ratio (CAR). The aim of the 1988 Capital Accord (Basel I) was to indicate a minimum recommended level of regulatory capital, with a CAR of 8%.

Being intended as a minimum, this level did not aim to represent the optimum economic level of capital for a bank, capital being a residual claim that "trades off effects on liquidity creation, costs of bank [financial] distress, and the ability to force borrower repayment" (Diamond and Rajan, 2000). Well-capitalized banks would tend to hold more than this minimum, especially as the Basel I Accord covered neither market risk nor operational risk. An amendment to the 1988 Accord was issued in 1996, dealing with the various forms of market risk: interest rate risk, equity position risk, foreign exchange risk, commodities (price) risk, and options. The target CAR remained at 8%.

During the 1990s, however, it became increasingly recognized that on the one hand the approach of Basel I to the measurement of credit risk was both over-simplistic and rigid, while on the other hand some account needed to be taken of operational risk. Moreover, the approach of banking supervisors to the regulation of capital adequacy and other matters should take account of the bank's own risk measurement and management skills (the so-called risk-based approach to supervision). With regard to credit risk, the system of risk weights called for considerable fine-tuning and elaboration to take account of various risk mitigants. Banks with the necessary capabilities should be able to use their own credit risk ratings in calculating their risk weights, rather than using the standardized weightings laid down in the Capital Accord. Other banks should be able to use credit ratings issued by approved external credit

assessment institutions (ECAIs) such as Moody's, Standard & Poors, and Fitch, when available, in arriving at credit risk weightings for their financial assets.

These considerations led to the preparation by the BCBS of a Revised Framework for capital adequacy, commonly referred to as Basel II, of which a final version was issued in June 2004, covering credit risk and operational risk. The Basel II document is long and complex, and its preparation involved considerable controversy. In addition to capital adequacy (its first "Pillar"), the Accord deals with the principles of supervisory review (Pillar 2) and market discipline (Pillar 3). The "fine-tuning" approach adopted in Pillar 1 has been criticized on a number of grounds. One criticism is that as a result of the fine-tuning, the distinction between the regulatory capital requirement (supposedly a minimum) and a bank's economic or "optimum" level of capital is no longer clear. Another criticism is the importance given to ECAI credit ratings in the "standardized" approach, although such credit ratings are confined to a relatively small proportion of credit risks, especially from an international perspective (Cornford, 2003, 2004).

One important issue was the combination of banking with securities operations in major European banks (so-called universal banks). Different capital adequacy criteria apply to banking and securities operations. This has led to the adoption of a "banking book" approach in the E.U. Capital Adequacy Directive 1993. Here, the securities activities as defined by the "trading book" are subject to a capital adequacy regime that is separate from the banking business as defined by the "banking book." One problem with this dichotomy is apparent when it is recognized that hedges of banking book items (such as hedges of foreign currency risk on financial assets) are typically handled through the bank's Treasury as part of its trading activities that belong to the "trading book."

#### 3. APPLICATION TO INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES – ISLAMIC BANKS

#### 3.1. Introduction

Typically, Islamic banks are somewhat similar to universal banks, in that they combine banking operations with trading operations, not necessarily in securities but in commodities and other non-financial

assets – for example, by means of salam and istisna'a contracts. However, they differ significantly in that they typically mobilize funds in the form, not of interest-bearing deposits, but of profit-sharing investment accounts (PSIA). This is relevant to the specification of the CAR: are PSIA part of the bank's risk-bearing capital (numerator of the CAR), and are the assets financed by PSIA part of the bank's assets which, on a risk-weighted basis, are included in the denominator of the CAR? This issue is discussed further in Sub-sections 3.2–3.4 below.

The calculation of risk-weighted assets is also affected by two factors:

- a. The risk characteristics of Islamic banks' assets differ in a number of cases from those of conventional banks, either: (i) because of their juristic (Shari'ah) attributes as financial assets; or (ii) because they are not financial assets but real estate, commodities, or work-in-process inventories (in the cases of ijarah, salam, or istisna'a assets, respectively); or (iii) because they result from financing made on a profit-sharing basis and are exposed to losses (for asset-side mudarabah and musharakah).
- Risk mitigation is affected by Shari'ah restrictions, such as those on guarantees and on the use of derivatives.

These are technical, rather than conceptual, issues that are dealt with in the IFSB Standard on Capital Adequacy, and will not be explored further here, except for asset-side *mudarabah* and *musharakah* which are discussed in Sub-section 3.6 below.

There are other, systemic, sources of difference that affect liquidity risk. These are the lack, in many countries, of Shari'ah-compliant cash equivalents that offer a return to the holder, of a Shari'ah-compliant interbank market, and of a Shari'ah-compliant lender of last resort facility. The effect of this on capital adequacy is a matter for Pillar 2 of the Revised Framework, and will be discussed in Section 4 below.

On a more fundamental level, one may ask to what extent Islamic banks share those characteristics of conventional banks that were mentioned above which lead to capital adequacy being an issue, and whether they have other, different, characteristics with capital adequacy implications.

 Are Islamic banks exposed to, and do they contribute to, the systemic risk of contagious collapse? To what extent do PSIA share the moral hazard implications
of deposits that are due to the effects of deposit guarantee
schemes?

#### 3.2. Islamic Banks, Financial Distress, and Systemic Risk

Because PSIA juristically are not debt claims (except in cases of misconduct or negligence by the bank), but a form of limited-term equity or residual claim, shocks to asset values for assets financed by PSIA are passed on to the PSIA holders and thus do not impact the bank's own capital. However, Islamic banks are not immune from "runs" in the sense of large volumes of "panic" withdrawals of PSIA funds, which might follow such shocks and could result in financial distress to an Islamic bank in the form of a liquidity crisis. As Dale (1996: 8) points out, a conventional investment firm faced by such problems "will generally be able to wind down its business in an orderly manner, meeting its obligations through prompt asset disposals at close to book value," since its assets "consist mainly of marketable securities and there will be little difference between [their] value on a going concern basis and in liquidation." However, Islamic banks tend to invest PSIA funds in assets that are relatively illiquid, such as murabahah, ijarah, and salam. PSIA holders typically have the right to withdraw their funds at short notice subject to forfeiting their share of profit (but not of loss) for the most recent period. Moreover, the investment activities of Islamic banks are conducted under the same corporate umbrella as their banking activities. Also, in the case of unrestricted PSIA, the funds are typically commingled with the bank's own funds. Hence, losses on asset disposals may impact the bank's own capital as well as that of PSIA. (This would not be the case for restricted PSIA funds, unless the bank had invested its own funds in the same asset pool.) PSIA holders who insist on withdrawing their funds must therefore suffer any resultant losses on asset disposals.

Hence, Islamic banks are not immune to systemic risk, but as described above it manifests itself primarily as liquidity risk. The exposure of the bank's own capital is limited to the effects of forced asset disposals on assets financed on a commingled basis, which should not normally be significant enough to imply a need for the regulation of capital adequacy. However, there may be factors owing to which the juristic nature of PSIA as a form of limited-term equity investment may be overlaid by economic characteristics closer to those of conventional deposits. These are discussed in Sub-section 3.5 below.

#### 3.3. Market Failure

The rationale for capital adequacy regulation of conventional banks depends partly on the social costs of contagious failure (systemic risk) and partly on the failure of market discipline owing to deposit guarantee schemes (as discussed in Sub-section 3.4 below). However, in the environments in which Islamic banks typically operate, there may be a more general lack of market discipline. This is suggested by recent research carried out by Ariffin (2005), and would provide an additional reason for capital adequacy regulation of Islamic banks.

### 3.4. Displaced Commercial Risk

The above reasoning is based on the juristic nature of PSIA as profitsharing and loss-bearing. However, this characterization requires some qualification, for three reasons:

- Unrestricted PSIA holders may be more risk-averse than Islamic bank shareholders, but the funds of the two categories of investor are typically commingled. Unrestricted PSIA holders seek a safe investment vehicle for their liquid funds and savings, comparable to conventional deposit accounts.
- This has led to Islamic banks practicing the smoothing of investment returns to PSIA, using a combination of reserve accounts (profit equalization reserve and investment risk reserve (AAOIFI, 1999a)) and, if necessary, the forfeiting of part or all of the bank's mudarib share of profit for a given year. This practice gives rise to displaced commercial risk (AAOIFI, 1999b).
- 3. Some banking supervisors have taken the view that this practice results in a modification of the legal attributes of the PSIA, such that the Islamic banks have a constructive obligation to continue the practice. In other words, instead of being voluntary, the practice becomes obligatory, unrestricted PSIA being regarded as virtually "capital certain," so that Islamic banks are severely restricted in their ability to pass losses on to unrestricted PSIA holders. Displaced commercial risk thus assumes an institutional character, with implications for capital adequacy.

The above considerations led the IFSB, in its Capital Adequacy Standard, to set out two alternative versions of the CAR for Islamic banks. In the first version, the credit and market risks of assets financed by PSIA are treated as being borne entirely by the PSIA holders. In the second version, a proportion  $\alpha$  (alpha) of the risk-weighted assets financed by *unrestricted* PSIA is included in the denominator of the CAR, which has the effect of requiring the Islamic bank to hold regulatory capital against the credit and market risks of that proportion of those assets. It is up to the national banking supervisor to determine the proportion  $\alpha$  for each Islamic bank in its jurisdiction. This issue is discussed in detail by Venkataraman Sundararajan in Chapter 3 of this volume.

In addition, recent research by IFSB (Islamic Financial Services Board, 2004) has shown that in some countries PSIA are covered by deposit guarantee schemes, even though this is not Shari'ah-compliant unless the scheme operates on the basis of takaful or is provided by the central bank free of charge. In such an environment, PSIA share (at least to some extent) those characteristics of conventional deposits that give rise to moral hazard and the consequent need for the regulation of capital adequacy.

# 3.5. Islamic Bank Capital and the Economic Characteristics of PSIA

The above discussion indicates that the economic characteristics of PSIA are complex and may vary between jurisdictions. In no cases are PSIA part of the bank's capital, but juristically they should be available to absorb all losses resulting from credit or market risk exposures in respect of the assets that they finance, in the absence of misconduct or negligence by the bank. In practice, however, PSIA may be partially assimilated to conventional deposits, with implications for the bank's own capital (displaced commercial risk), and may even be covered by deposit guarantee schemes. In such cases, as indicated in Sub-section 3.4 above, there are implications for the Islamic bank's capital adequacy that need to be taken into account by including some proportion of the assets financed by PSIA, on a risk-weighted basis, in the denominator of the CAR.

Do PSIA give rise to moral hazard problems similar to those associated with conventional deposits? Certainly, as Al-Deehani, Karim, and Murinde (1999) point out, Islamic banks have incentives to maximize the amount of PSIA that they control. Because PSIA are not liabilities, there is in principle no hard financial constraint on the volume of PSIA funds taken on by a bank; the bank benefits from the *mudarib* share of profits on managed funds, while incurring only the payroll and associated costs of providing asset management. The constraint is thus a soft constraint of managerial capacity to provide effective asset management, in a context where economies of scale are significant. It is not clear that Islamic banks have any incentive to take on amounts of PSIA funds in excess of what they can effectively manage. However, there could be a problem of incentive misalignment insofar as the unrestricted PSIA holders are likely to be more risk-averse than the bank's shareholders. This leads to a type of moral hazard problem that is associated with displaced commercial risk. Hence, in environments where displaced commercial risk is a significant factor, the volume of unrestricted PSIA has capital adequacy implications, as discussed above.

### 3.6. Risk Weights for Profit-sharing Assets

Islamic financing assets that are profit-and-loss sharing (musharakah financing) or are profit-sharing and loss-bearing (mudarabah financing) are not easily accommodated within the credit risk methodology of the Basel Accords, and therefore called for particular attention from the IFSB in its Capital Adequacy Standard. Where the musharakah or mudarabah assets are commodities or other assets that are held for trading, the risk involved is essentially the market risk of those assets, and there is no particular problem of credit risk.

However, when the mudarabah or musharakah is used as a means of financing and the assets are intended to be held to maturity, the risk is essentially a credit risk - namely, a risk of capital impairment. The provisions of Basel II include a category of credit risk referred to as "equity position risk not in the trading book" - that is, in the "banking book." This category is primarily intended to cater for shares held by banks as long-term investments in companies with which they have a lending relationship, which is a familiar feature of "relationship banking" in some continental European countries. Such shares may or may not be listed on a recognized stock exchange. However, some types of musharakah investment, typically those in a business venture, combine the risk of an equity position (normally unlisted) with a "banking book" intention to hold the investment to maturity. Hence, the IFSB Standard proposes a risk weighting for such assets that is similar to that set out in Basel II for equity position risk exposures in the banking book. Alternatively, some musharakah and mudarabah investments, especially diminishing musharakah, could be seen as a category of "specialized lending" for which Basel II provides 
"slotting criteria" for arriving at risk weightings. The IFSB Standard 
allows the use of risk weights based on such criteria as an alternative 
to those resulting from treatment of such assets as equity positions in 
the banking book.

The credit risk weightings resulting from the approaches just outlined are high compared to those on other financing assets such as murabahah or ijarah muntahia bittamleek, and in the case of "equity position risk in the banking book" very high, in the absence of risk mitigation. This emphasizes the importance of financing structures in such cases that serve to mitigate credit risk and has implications for banking supervisors, as mentioned in Section 4 below.

# 4. PILLAR 2 OF THE REVISED FRAMEWORK AND RISK MANAGEMENT

#### 4.1. Introduction

Pillar 2 of Basel II is concerned with the supervisory review process, which "is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their assets. . . . Supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate" (Basel Committee on Banking Supervision, 2004:paras 720 and 722). The following risks are mentioned specifically in the order given below (Basel Committee on Banking Supervision, 2004:paras 733–742), but this list is not intended to be exhaustive:

- · credit risk
- · operational risk
- · market risk
- · interest rate risk in the banking book
- liquidity risk
- · other risks, such as reputational and strategic risk.

From the perspective of Islamic banks, the following call for comment in this section: credit risk; an analogue of interest rate risk in the banking book – namely, displaced commercial risk; and liquidity risk, an increase in which may be one of its consequences.

#### 4.2. Credit Risk

Apart from Islamic banks' credit risk methodologies and systems in general, the analysis in Sub-section 3.6 above indicated a particular need for supervisory attention to the measurement and management of credit risk arising from profit-sharing and loss-bearing assets. Among other matters, supervisors will need to decide which of the two risk measurement methodologies is more appropriate: the market-based approach for equity exposures in the banking book with its high risk weights; or the supervisory slotting criteria approach for specialized lending with its lower risk weights. In principle, the latter approach should be authorized only when the supervisor is confident that the slotting criteria are appropriate for the credit risk exposures and will be correctly applied.

### 4.3. Displaced Commercial Risk

In conventional banking, interest rate risk in the banking book results from mismatches between assets and liabilities as a result of which the rate payable on liabilities exceeds that receivable on assets, thus subjecting the bank to an "interest rate squeeze" which may threaten its viability. For Islamic banks, while there is no interest payable or receivable, there are returns receivable of a mark-up nature (for example, on murabahah assets) or ijarah rentals that are fixed in advance, while the returns expected by PSIA holders (especially for unrestricted PSIA) follow current market expectations. The result is a similar kind of squeeze that leads to displaced commercial risk, The severity of this squeeze and its implications for capital adequacy will depend, among other things, on the economic characteristics of unrestricted PSIA in the country concerned, as discussed in Section 3 above. This matter will therefore call for particular attention from supervisors under Pillar 2. Supervisors will need to evaluate the risk management systems of Islamic banks in their jurisdiction, and their exposure to and capability to manage displaced commercial risk.

### 4.4. Liquidity Risk

When Islamic banks are not considered to have a constructive obligation to maintain the capital of unrestricted PSIA, they may nevertheless face considerable commercial pressure and resultant risk of the withdrawal of PSIA funds – that is, liquidity risk. For systemic reasons mentioned in Section 3 above, liquidity risk tends in any case to be a particular problem for Islamic banks. Supervisors will need to pay particular attention to the issue of whether Islamic banks in their jurisdiction have "adequate systems for measuring, monitoring and controlling liquidity risk . . . [and for evaluating] the adequacy of capital given their liquidity profile and the liquidity of the markets in which they operate" (Basel Committee on Banking Supervision, 2004:para. 741).

#### 5. CONCLUDING REMARKS

This chapter has reviewed some salient issues in the matter of regulating the capital adequacy of Islamic banks, against the conceptual background of capital adequacy regulation of banks in general. The justification for capital adequacy regulation in the case of conventional banks lies partly in the social costs of contagious collapse (systemic risk), and partly in the lack of market discipline whereby, if fully effective, inadequately capitalized banks would be obliged by market forces to obtain adequate capital or to curtail their activities. A major reason for this lack of market discipline is the existence of deposit guarantee schemes that reduce market incentives to monitor banks.

The analysis above indicated that both the social costs and the market failure rationales apply to Islamic banks, but with some differences as compared to conventional banks. With regard to the social costs rationale, in principle PSIA impose requirements for liquidity rather than capital adequacy. However, a major issue for international guidelines on capital adequacy is the variations between countries in the economic characteristics of unrestricted PSIA. In some countries, they are considered to impose constructive obligations on Islamic banks comparable to those imposed by conventional deposits: in other countries they impose commercial constraints that have a similar effect. In such countries, unrestricted PSIA may account for a large proportion of the funds mobilized by Islamic banks. This leads to the problem of displaced commercial risk in such countries. In other countries, the treatment of unrestricted PSIA is more in accord with their juristic nature in the Shari'ah, while in yet other countries (such as Saudi Arabía) Islamic banks avoid offering unrestricted PSIA at all. Hence, international capital adequacy guidelines must leave scope for national bank supervisors to apply a capital adequacy regime in respect of unrestricted PSIA that fits their economic characteristics in the local environment.

With regard to the market failure rationale, research indicates that market discipline tends to be weak in the countries in which Islamic banks operate. Also, in some countries, unrestricted PSIA are covered by deposit guarantee schemes. For these reasons, capital adequacy cannot be left to market forces, but requires the intervention of the banking supervisor.

Thus, the rationales for the regulation of capital adequacy for conventional banks are applicable to Islamic banks. Technical rather than conceptual differences exist in the identification, measurement, and mitigation of credit risk and market risk. In the case of asset-side musharakah and mudarahah, the differences are more of a conceptual nature, as such profit-sharing and loss-bearing investments are not normally found in the "banking book" of conventional banks, and if they do exist they receive a very high risk weighting under Basel II. Under appropriate circumstances, and at the supervisor's discretion, they may, however, be considered under the "specialized lending" provisions of Basel II which involve less onerous risk weightings. Nevertheless, a major conceptual difference (and problem) concerns the economic characteristics of unrestricted PSIA, which vary from their being regarded as virtual deposits (that is, not loss-bearing, and entitled to a fairly predictable return) in some countries, to their being considered in other countries as essentially a form of limitedterm equity investment (a position more in line with their juristic nature in accordance with Shari'ah principles). These differences have substantial implications for capital adequacy and for the calculation of the CAR.

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# Measuring Operational Risk

Elisabeth Jackson-Moore

#### 1. INTRODUCTION

To until very recently, operational risk was felt to be inherent in all banking operations but impossible to quantify, difficult to measure even qualitatively, and so subjective in its management and control. The decision by the Basel Committee to include a capital allocation for operational risk in its New Capital Accord (November 2005), generally known as Basel II, focused minds. Over the last five years, especially, banks around the world have begun to collect data on operational losses and to develop systems based on this, and external data, to allow them to model the occurrence and severity of losses and to use these models to estimate their economic capital requirement.1 Interestingly, though, in a recent survey carried out by the Risk Management Association, the main reasons given for investing in operational risk were to improve performance, reduce operational losses, increase accountability and improve governance, and protect against the loss of reputation. Meeting Basel II regulatory requirements was of least importance. Prompted by the Basel Committee, banks have become aware of the importance of measuring. managing, and controlling their operational losses.

In January 2006 the Islamic Financial Services Board (IFSB) issued its first two standards on risk management in Islamic financial institutions and capital adequacy for Islamic financial institutions. Operational risk, its management, and its use in calculating risk-based capital form part of these standards.

The IFSB Standard No. 1 covers guiding principles for risk management in institutions offering Islamic financial services. While referring to the definition of operational risk used by the Basel Committee – namely, the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events – it also highlights additional operational risks faced by Islamic financial institutions. These it defines as the risks relating to Shari'ah compliance and those associated with the institutions' fiduciary responsibilities toward different fund providers.

The IFSB Standard No. 2 covers capital adequacy for institutions offering Islamic financial services. It states that the measurement of capital to cater for operational risk may be based on either the Basic Indicator Approach or the Standardized Approach as set out in Basel II. Under the Basic Indicator Approach, a fixed percentage of 15% of annual average gross income, averaged over the previous three years, is set aside. Under the Standardized Approach, this percentage varies, according to the line of business (LOB), from 12% to 18%, being 18% for corporate finance, trading and sales, and payment and settlement, 15% for commercial banking and agency services, and 12% for retail banking, asset management, and retail brokerage. As the LOBs into which institutions offering Islamic financial services (IIFS) are organized are different from the above, the IFSB proposed that, at the present stage, the Basic Indicator Approach be used by IIFS, which requires the setting aside of a fixed percentage of average annual gross income over the previous three years. However, subject to the supervisory authority defining the applicable business lines, the supervisory authority may allow IIFS in its jurisdiction to apply the Standardized Approach in which a percentage (12%, 15%, or 18%) of gross income is to be set aside according to the business lines.

The intention of the Basel Committee in framing its proposals is that banks should be encouraged to move, over time, to the more sophisticated measures, leading ultimately to the Advanced Management Approach (AMA), providing that certain requirements are met. In theory, the capital needed by those banks that can show greater sensitivity to the risks, and which have adopted more refined measurement systems and practices, should be less.

While the IFSB focused on two additional areas of operational risk for Islamic institutions, it is intuitively an important consideration for Islamic banks. Some of the issues have been raised in earlier chapters,

## but are worth repeating here:

- Islamic banking began in the form we see today as recently as the mid-1970s; as a result, the systems, processes, and products are all relatively recent developments and have not yet reached the mature position where the major problems and risks have been identified and eliminated.
- Islamic (that is, Shari'ah-compliant) products are mainly contract-based and so intrinsically more vulnerable to documentation error and legal risk.
- Islamic products also tend to be more complex than their conventional counterparts, requiring more processing steps and hence leaving more room for error.<sup>2</sup>
- Islamic banks typically hold more physical assets on their balance sheets than conventional banks and are exposed to operational risks associated with these.
- Computer software used by IIFS is inherently less robust than the well-tested and proven packages developed for conventional banks. These packages are inappropriate for many of the operations of Islamic institutions.
- There is a shortage of skilled bankers who are also versed in Islamic Shari'ah, leading to increased "people" risks.
- There are risks, as identified by the IFSB, in Shari'ah compliance and also arising from the nature of investment accounts and other funding sources. These are not risks found in conventional institutions.
- There are still further risks, in all these areas, as a result of the rapid growth in Islamic finance over the last few years that can strain resources.
- Insurance has been a significant mitigant of operational losses for conventional banks; it is not clear to what extent Islamic banks have been able to employ this practice given the relatively low use and scope of Islamic insurance (takaful) at present. (Many Islamic banks may use conventional insurance in the absence of other suitable products.)

It is, of course, true that most Islamic banks do not have the risks associated with the more complex derivative products and trading activities that are a significant feature of the most sophisticated conventional banks today, and it is these products and operations that have generally given rise to the most significant, catastrophic, loss events (from Barings to Allfirst).

At present, there is no data to suggest that the greater risks we see arising as a consequence of the operations of Islamic banks actually lead to more operational losses than seen in their conventional counterparts. It may be that the lack of traded-product complexity more than compensates for other risks. However, as a result of the many, somewhat unique, operational risks, there is an especial need for IIFS to identify, measure, monitor, and control their operational risks, and for supervisors to take account of them in setting the parameters for capital adequacy purposes.

# 2. BASEL COMMITTEE - LOSS DATA COLLECTION EXERCISE

As the Basel Committee has been refining its proposals for a revised capital adequacy regime it has been collecting data from financial institutions, through a series of quantitative impact surveys, in order to marry their risk-based capital adequacy proposals with the actual risk experience of banks. In 2001, as part of the second survey (OIS2-Tranche 1), banks were asked to provide information on capital allocation for operational risks. A second exercise (OIS2-Tranche 2) focused on information about individual loss events. In 2002, the Risk Management Group of the Basel Committee launched a further survey named the Operational Risk Loss Data Collection Exercise (LDCE). The results of the LDCE confirmed that the industry had made progress in its operational risk data collection efforts. While there was evidence of clustering around certain business lines and event types, perhaps the most striking feature was the large variation in the number of events reported, partly attributed to gaps in data collection. For the 89 participating banks the number of individual loss events ranged from just one event to more than 2,000. Forty-nine banks reported 200 or fewer loss events, while eight banks reported over 1,000 individual loss events. Results of the exercise have been presented in various ways, generally tabulated by line of business and event type.3 Overall conclusions show that most loss events occurred in retail banking, with over 61% of reported incidents; however, these losses only accounted for 29% of monetary losses, very similar to the level reported for commercial banking. Most events related to external fraud (42%), although this was followed by execution, delivery, and process management (35%) with this latter event-group topping the list in monetary terms (29%) followed by damage to physical assets (24%).4

Of the 89 banks participating in the 2002 LDCE, 60 provided information on their economic capital calculation. Of these 60 banks, 47 provided information on economic capital for operational risk, which on average was 15% of the total economic capital. However, the ratio varied considerably across banks, with the minimum amount being 0.09% and the maximum 41%. Many of the banks provided information by business line, and here retail banking stood out with a mean value of over 45%. The report points out, though, that the apparent concentration in retail banking probably reflects business focus as much as the inherent degree of operational risk in retail banking activities. Further, differences in the definition of economic capital and in calculation methodologies could make the data submissions not fully comparable and therefore contribute to non-risk-related differences across business lines.

This average value of 15% has been adopted for the Basic Indicator Approach, despite the fact that this will be only a very rough approximation of the appropriate level for many banks. (The first consultative paper suggested 20%, while the second revised this number down to 12%.) Under the final proposals, capital equal to 15% of annual gross income averaged over three years should be set aside for operational risk. As banks improve their measurement techniques, it is likely that further revisions will be made to the percentage. This is also true for the percentages proposed under the Standardized Approach. The 18% level is set for LOBs that account for the highest severity of loss, but the percentages of 18%, 15%, and 12% are still very crude buckets at this stage in the development of operational risk measurement and management.

Because the percentages proposed are still so arbitrary, even though the LOBs may not seem entirely appropriate for Islamic institutions, it could be that an appropriate mapping exists and would be an improvement over the flat rate of 15%. However, if the amount of capital required for operational risk is ever to be more than an arbitrary number for Islamic institutions, priority must be given to measuring operational risk and recording loss data. Preferably this should be done on a global basis for all Islamic finance institutions to common standards, as it seems likely that only by such aggregation can realistic conclusions be drawn.

### TOOLS USED TO IDENTIFY AND MEASURE OPERATIONAL RISKS

Partly as a result of the focus given to operational risk by Basel II, many consultancy firms have developed various methodologies for identifying and measuring operational risk in banking institutions and the largest banks have been using their own, and external resources, to tune their systems. For many it has been the first time that any attempt has been made either to collect data or to identify risk areas, or at least to formalize the structure. At this point, no one method has become the preferred method and most banks are using combinations of techniques to hone their systems. This disparity in approach is probably one of the reasons behind the varied responses to the LDCE.

Key to the success of any approach is ensuring that there is "buyin" to it throughout the organization, from board members to staff
in all business units. Top management must develop a culture that
encourages full cooperation by everyone, so ensuring the integrity of
the systems and processes that are established. There are a number of
ways in which the organizational structure can be set up; much will
depend on the size of the institution and the existing risk management
framework. However, operational risk experts will be needed for any
successful implementation, and it has often been found helpful to
assign responsibility for operational risk to someone in each business
unit, with accountability resting with the head of the business unit.

Several surveys have been carried out to ascertain the latest trends in operational risk management.<sup>5</sup> The results show that most of the institutions surveyed have adopted some form of self-assessment technique. These can take many forms and, although time-consuming, can easily be applied by institutions of all shapes and sizes. In general, they are used in a bottom-up approach, focusing on business areas, with managers and staff in these areas identifying potential risks and often scaling these risks. Some still regard these techniques as too subjective, and in many banks the process is still a manual one, even though software is readily available to assist in the implementation. Risks can be classed in a simple way by likelihood of occurrence and by likely severity of loss. These classifications can then be mapped against the institution's risk tolerance with the aim of bringing down those risks that lie outside these tolerance levels by changing processes, systems, and/or people.

Key risk indicators (KRIs) are being used increasingly by many institutions, often as a top-down method of identifying trouble spots in the organization. The approach tries to use both qualitative and quantitative factors in a predictive rather than a causal way. Indicators can be identified at the LOB level. They can include such measures as transaction volumes, portfolio size, staff numbers, and IT budgets. Some banks are collecting hundreds of potential indicators. These factors are tracked over time and regressed against loss data. This becomes an iterative process, with the variables being modified over time so that the indicators provide some early warning of potential losses. Many consultants offer services in this area; in addition, others, such as the Risk Management Association, have been active in pooling information provided by member institutions who are able to share experiences.<sup>6</sup>

Key to any methodology, however, is the data collection process. Most banks are still at an early stage in developing this. Banks are still learning what information is required about each incident in order to use it in the most constructive way. Some of the questions asked are:

- · What cut-off should be employed?
- What causal data are needed?
- What to do when there is overlap with credit or market risk?
- Should "near miss" incidents be recorded indeed, how to define a "near miss"?
- Are indirect losses also monitored?
- What about incidents that in fact lead to direct or indirect gains?

While there are no right or wrong answers to these questions, it is clear that banks need to institute an incident management mechanism, rather than a simple data collection process.

While it is unlikely that most Islamic institutions will be in a position to model their loss data in a way that would qualify for the Advanced Measurement Approach as described in Basel II for some time, it is important that the information collected should be capable of being used in such a model in the future. One of the main problems facing the "modelers" today is not how to treat the low-impact/high-frequency events for which several normal-related distributions are appropriate, but rather how to model the high-impact/low-frequency ones. At present, extreme value theory (EVT) is being tested, but it seems unlikely that this will have high predictive power for the types of events that cause most concern – the fraudulent managers, reckless lenders, and rogue – or even careless – traders.

#### 4. EXTERNAL DATA

Reference was made earlier to the need for Islamic institutions to come together and pool information on operational risks in order to arrive at a body of data that is sufficiently robust to allow meaningful scale factors to be applied to the calculation of the capital requirement for LOBs. The need for a larger pool of data is not limited to Islamic institutions, and some regulators are collecting national data, as are some bank associations. In addition, there are a number of vendors who have collected loss information from publicly available sources.7 This data poses certain challenges, as not all losses are publicly disclosed. It seems likely that the probability of a loss being publicly reported will increase as the amount of the loss increases, although there will be significant variation across countries depending on the size and importance of the banking system in that country. However, while banks will hope to have no more than a handful of high-impact events, these databases will gather many more and so can provide useful information on the important "tail" in the loss distribution. These external databases have focused on losses in the United States, Europe, and Japan, and so have relatively few entries that relate to Islamic institutions. Indeed, a fairly recent search only produced references to losses incurred in the aftermath of the collapse of Bank of Credit and Commerce International (BCCI).

#### 5. CONCLUSIONS

Operational risk is now recognized for what it is: an area that can lead to significant losses in all financial institutions, but one that can be measured and managed in an increasingly sophisticated and meaningful way. While the various techniques being applied in banks today are still in their early stages of development, significant progress has been made over the last five years.

It is never too early for a bank to start collecting data, and there can be significant advantages in pooling information and using common definitions, standards, and methodologies. While no one approach can provide all the answers, some of the simpler methods, although requiring a commitment in staff time at the business unit level, can produce useful insights into processes, people, and systems that can lead to improvements in all areas that can reduce the losses likely to be faced as a result of operational risks.

## ANNEX 1

## Mapping of business lines as set out in Basel II

Level 1	Level 2	Activity groups
Corporate Finance	Corporate Finance Municipal/ Government Finance Merchant Banking Advisory Services	Mergers and acquisitions, Underwriting, Privatizations, Securitization, Research, Debt (Government, High-yield), Equity, Syndications, IPO, Secondary Private Placements
Trading and Sales	Sales Market Making Proprietary Positions Treasury	Fixed Income, Equity, Foreign Exchanges, Commodities, Credit, Funding, Own Postition Securities, Lending and Repos, Brokerage, Debt, Prime Brokerage
Retail Banking	Retail Banking Private Banking	Retail Lending and Deposits, Banking Services, Trust and Estates Private Lending and Deposits, Banking Services, Trust and Estates, Investment Advice
	Card Services	Merchant/Commercial/Corporate Cards, Private Label and Retail
Commercial Banking	Commercial Banking	Project Finance, Real Estate, Export Finance, Trade Finance, Factoring, Leasing, Lends, Guarantees, Bills of Exchange
Payment and Settlement	External Clients	Payments and Collections, Funds Transfer, Clearing and Settlement
Agency Services	Corporate Agency Corporate Trust	Escrow, Depository Receipts, Securities Lending (Customers), Corporate Actions Issuer and Paying Agents
Asset Management	Discretionary Fund Management Non-discretionary Fund Management	Pooled, Segregated, Retail, Institutional, Closed, Open, Private Equity Pooled, Segregated, Retail, Institutional, Closed, Open
Retail Brokerage	Retail Brokerage	Execution and Full Service

#### Event types: Levels 1 and 2

Event type: Level 1	Event type: Level 2
Internal Fraud	Unauthorized activity Theft and fraud
External Fraud	Theft and fraud Systems security
Employment Practices and Workplace Practices	Employee relations Safe environment Diversity and discrimination
Clients, Products, and Business Practices	Suitability, disclosure, and fiduciary Improper business or market practices Product flaws Selection, sponsorship, and exposure Advisory activity
Damage to Physical Assets	Disasters and other events
Business Disruption and System Failures	Systems
Execution, Delivery, and Process Management	Transaction capture, execution, and maintenance Monitoring and reporting Customer intake and documentation Customer/client account management Trade counterparties Vendors and suppliers

### **ENDNOTES**

- See, for example, Deutsche Bank's annual report for 2005 where 18.5% of their economic capital is to cover operational risk.
- <sup>2</sup> For instance, see the personal finance example given in McKinsey's World Islamic Banking Competitiveness Report 2005–2006 contrasting goods murabahah and a cash loan.
- <sup>3</sup> See Annex 1 for a description of levels 1 and 2 descriptors of LOBs and event types.
- <sup>4</sup> See The 2002 Loss Data Collection Exercise for Operational Risk: Summary of the Data Collected, published by the Bank for International Settlements in March 2003, for further details.
- See, for example: Operational Risk Management & Basel II Implementation: Survey Results, Fitch Ratings, August 2004; Emerging Trends in Operational Risk within the Financial Services Industry, Raft International; Emerging Best Practices for Operational Risk Management at European Banks, Moody's Investors Service, October 2004.
- <sup>6</sup> The Risk Management Association set up KRI Services in January 2005. It provides subscribers with access to a KRI Library and KRI Benchmarking Services. It has established a number of Working Groups around the world and also organizes conferences on the issue.
- <sup>7</sup> See, for instance, the OpVantage database (a division of Fitch Ratings) or OpRisk Global Data, owned by the SAS Institute.

# Supervisory Implications of Islamic Banking: A Supervisor's Perspective

**Toby Fiennes** 

In looking at Islamic banking from a supervisor's perspective, the first question must be to ask what a banking supervisory system is designed to achieve. Banking supervisors around the world are a diverse bunch and banking supervisory systems reflect that. There are, though, two objectives that are – sometimes implicitly, sometimes explicitly – common to almost all countries. They are:

- · the desire to protect individual consumers in banks
- · the need to prevent systemic failure of the banking system.

The typical banking supervisor will be guided by these objectives in his or her day-to-day work. Ultimately, bank failures have a huge range of causes, but the immediate trigger is a shortage of either capital (that is, the bank is insolvent) or liquidity.

The supervisor spends time analyzing and – one hopes – ensuring the bank mitigates, where appropriate, risks to solvency or liquidity. That is what supervisory frameworks such as the Basel capital regime are designed to achieve.

For the supervisor of an Islamic bank, the objectives are in principle the same. I shall therefore cover the following in this chapter:

 Whether there is anything about Islamic banks that makes them more or less vulnerable and, in turn, whether Islamic banks make "the system" more vulnerable.

- How a supervisor might think about the question of protecting "depositors" in Islamic banks. (The word "depositors" is not necessarily suitable, as I shall discuss below.)
- · Whether any particular issues apply to Islamic "windows."

In passing, I should note that some supervisory authorities also have a role in monitoring or enforcing Shari'ah compliance. This may be a pragmatic option in countries where the supervisor is both authoritative and suitably skilled. However, my personal belief is that such a model may give rise to conflicts of interest between religious objectives and financial objectives.

## 1. VULNERABILITIES OF ISLAMIC BANKS

All banks face risks. Islamic banks face substantially the same ones as conventional banks and these can be found in any good banking textbook. I shall focus entirely on the particular risks that Islamic banks face and how they could deal with them. The Basel II framework is helpful in exploring these issues. Credit, market, and operational risk are all present in today's Islamic banks and these are sometimes magnified because the products are new.

For credit risk, the issues are not much different from those found in conventional banking; where there is a difference, it is usually because there is an added dimension, such as market risk, and not because of the inherent riskiness of the product. Indeed, market risk can be a significant feature of some Islamic products, such as salam — where a bank agrees to take delivery of a commodity at a future date in repayment of a financing facility. Here the bank is exposed to the traditional credit risk associated with any financing, but also to the market risk that the price of the commodity may move unfavorably.

Under some Islamic banking financing products, notably mudarabah and musharakah, the bank enters into a profit-sharing and loss-bearing or a profit- and loss-sharing partnership with its customer. There is no real conventional equivalent: the nearest is probably venture capital. In its purest form, profit- and loss-sharing ventures carry significant risks – of fraud or misrepresentation by the customer; and simply that there is a higher probability of loss than under a conventional bank financing.

In one respect, Islamic banks tend to run lower levels of market risk than many of their conventional counterparts: because of concerns about speculation, it is unlikely that we will see Islamic banks with huge investment-bank-style trading rooms, taking large proprietary positions. But they are exposed to many of the same market risks as conventional banks – and maybe to more equity position risk "in the banking book" if they take stakes in the businesses they finance.

It is, though, in the area of operational risk that there is most room for debate. Islamic banks are exposed to unique and, frankly, higher risks, especially legal and reputational ones. These, combined with the leading-edge nature of some of the products, raise the risk profile of some Islamic firms.

Islamic banks run a number of unique operational risks, including the following.<sup>1</sup>

- They are exposed to particular legal risks. These vary across jurisdictions. In many Western countries, the fact that the documentation is new and not well-tested in the courts adds to the legal risk. There is also the question of the interaction of commercial law with Shari'ah. If they conflict, there is at least the possibility that a defaulting party can try to evade his responsibilities by claiming non-compliance with Shari'ah. That was actually tried in a recent U.K. case, but the courts were not impressed. This case, Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco Pharmaceuticals Ltd and Others, 2004, is discussed in some detail in Chapter 7.
- What might broadly be called reputational risk is critically
  important to an Islamic bank, whose whole business model
  depends on ensuring Shari'ah compliance at all times. We
  would expect to see Internal Audit cover not just classic controls
  but also that Shari'ah compliance was adhered to throughout
  the organization. To do that, Internal Audit needs the relevant
  skills.
- Finally, IT risk stems from the fact that Islamic banking is a young industry. There is simply not the depth of software and processing products available.

But there are some inherent mitigants to the additional credit, market, and operational risks. First, many products are asset-backed: they have to comply with *Shari'ah*. This, for example, ought to make *sukuk* less risky than conventional bonds. Also, the fact that the contract between bank and customer is grounded in ethical considerations makes it less likely that a customer will seek to defraud the bank – or so one would hope.

A related point is the fact that, for some Islamic products, the relationship is seen more as a partnership between bank and customer. Other things being equal, this means that a bank will be closer to the customer and so will have earlier warning of potential problems. And finally, profit-sharing and loss-bearing accounts may be a useful mitigant for the bank; with losses borne by the investor, the bank's own capital is less at risk.

#### 2. BASEL II

Having run through those risks, let us move on to Basel II. It was developed with conventional banks in mind but is deliberately flexible. The use of internal models, for example, means that, in principle, almost any new product can be accommodated. So, how do Islamic banks fit within Basel in practice? The question "Can banks be both Shari'ah-compliant and Basel II-compliant?" is often asked and has a simple answer: "Yes." To see how, let us examine how the three pillars of Basel II relate to Islamic banks and Islamic products.

Pillar 1, the calculation of minimum capital requirements, has not explicitly catered for Islamic products. There is therefore a need for the development of international standards for the treatment of Islamic products – for two reasons: to ensure a level playing field internationally; and to save every country having to reinvent the wheel. Given that Islamic products are generally designed to compete with their conventional counterparts, they should in principle be accorded the same capital treatment provided the risks are substantially the same. This is not always the case, with Islamic home finance likely to attract a 100% weighting, against 35% for conventional mortgages. In the European Union, amendments to the European directive seem likely to put Islamic mortgages on an equal footing.<sup>2</sup>

The work of the Islamic Financial Services Board (IFSB) is crucial and invaluable. They have issued a capital adequacy standard for all Islamic products. The standard is firmly rooted in Basel II, and to a large degree is simply trying to interpret and apply Basel II to Islamic products. For example, *mudarabah* financing contracts will be treated either as equity positions in the banking book or as specialized financing subject to supervisory slotting criteria for risk weighting. *Salam* contracts will carry credit risk on the customer (before delivery of the goods) and then market risk on the value of the goods before they are sold. It was not always easy to do so, but the IFSB working

group looking at this - on which I sat - had detailed discussions and now has a full range of treatments for the products.

As I noted, operational and legal risks may be higher for Islamic banks. This implies a higher add-on for such risks, including *Shari'ah* non-compliance. It is up to individual supervisors how to take this into consideration, but an add-on of about 3% seems about right.

Islamic banks may have considerable off-balance-sheet assets in the form of "restricted investment accounts." Essentially these are funds under management, and a conventional bank would suffer an operational risk charge. Islamic banks may be more vulnerable, as the customer perception could be that the bank has a greater fiduciary duty. In some countries they have required banks to take 50% of such assets into the risk-weighted assets calculation (as proposed in the 1999 Statement on Capital Adequacy issued by the Accounting and Auditing Organization for Islamic Financial Institutions, or AAOIFI). I am not convinced of the necessity of that, as (assuming that "displaced commercial risk" as discussed below is not applicable) it is captured by the operational risk charge.

The final area of contention is what is called "displaced commercial risk." This arises because Islamic banks in practice often forego, for commercial reasons, part of their mudarib share of a profit-sharing and loss-bearing contract with a depositor. While in principle it has full discretion as to whether it displaces this commercial risk, in practice it may be virtually obliged to do so. This has implications for its capital, and supervisors should review whether added regulatory capital should be set aside. This issue is addressed in the IFSB's capital adequacy standard (see also Chapter 3).

The treatment of unrestricted investment accounts that appear on the "liability" or funding side of a bank's balance sheet has generated much debate. The issue is that for Islamic banks, unlike for conventional banks, these customer "deposit" accounts, being made under a profit- and loss-sharing and loss-bearing (PLS) mudarabah contract, in principle bear the risk of the proportion of assets that they finance. Logically, this could imply that Islamic banks do not need as much capital in relation to balance sheet assets as conventional banks. However, regulators – and, to be fair, the banks themselves – do not always see it that way. The Islamic banks are by and large keen to show that they are as healthy and well-capitalized as other banks; and the loss sharing may not always be available in practice, for commercial reasons.

There are at least four alternatives for the treatment of PLS accounts:

- No concession and no special treatment for Islamic PLS accounts (that is, treatment like conventional deposits).
- Adopt the capital adequacy treatment set out in the IFSB capital adequacy standard (as discussed in Chapter 3, Section 4).
- Move completely outside the Basel framework and treat the Islamic bank like a mutual fund which in a way it is. In this case, the 8% capital ratio becomes unnecessary. However, this is not practical as the PLS accounts are commingled with the bank's own funds and with non-interest-bearing current accounts. The only way to square this circle would be to establish separate legal entities for each type of account holder, effectively taking all the PLS accounts off balance sheet.
- The final option is to structure the "liabilities" side of the
  balance sheet according to a system of subordination of the
  rights of different categories of account holders. This would
  be accompanied by risk categorization on the asset side. It
  would involve a lot of work and due diligence by both the
  bank and the regulator and is probably unworkable, while
  attractive in theory. Such a structure might also raise issues of
  Shari'ab compliance.

In practice, regulators are expected to opt for the first or the second option.

# 3. PROFIT-SHARING AND LOSS-BEARING DEPOSITORS

Let us now look at the regulator's perspective on investment account holders (IAHs), especially unrestricted IAHs; that is, profit-sharing and loss-bearing depositors.

Regulation of deposit takers is essentially prudential in nature. The customer is assured of full repayment, provided the bank remains solvent. On the other hand, if capital certainty is not assured, then there has to be a role for the regulator in ensuring that the bank treats its customers fairly.

The possibility of capital loss, and the variability of the return, mean that prudential regulation is not enough. Only with full transparency and legal clarity (how much a customer will actually gain or lose, and under what circumstances) can the appropriate degree of consumer protection be ensured. The onus is on the bank, as the more sophisticated party, to explain fully and clearly both the risk and the potential reward of the product.

Having said that, my own personal view is that neither the bank nor the customer should think they can have it both ways. Either the product is capital certain, or it is not! A temptation exists in Islamic operations to fudge the issue and for banks to say that "in practice" the deposit is safe, but Shari'ah compliance means there is a theoretical risk of loss of capital. This point applies to Islamic operations in conventional banks, as much as to pure Islamic banks.

The PLS concept is unique to Islamic banks and gives rise to new and different conflicts of interest between stakeholders. From a regulatory and governance point of view, it is best to treat IAHs like mutual fund holders and to provide the same type of protection. This has implications. First, the Islamic operation must have a detailed policy for managing conflicts. These conflicts arise in the same way as in other parts of the securities industry. For example, there is the possibility of "insider dealing" – someone who knows that the bank is about to announce a large loan loss may withdraw their own deposit and encourage their friends to do so. Related is the question of market timing: banks should aim to publicise their results and to alert stakeholders to any major events as soon as possible. This is exactly what stock exchange rules expect of listed companies, for the same reasons.

Ultimately, the best protection IAHs can get is transparency and full disclosure. This should extend from transparency of the underlying legal contract between bank and customer to transparency and regular, timely disclosure of the relevant profit and performance measures. The IFSB is working on a project for a standard on Transparency and Market Discipline (TMD) to address these issues.

## 4. ISLAMIC WINDOWS

In the West, at least, Islamic banking tends to be conducted within divisions of conventional banks – so-called Islamic windows. This gives rise to particular issues of segregation – not just for Shari'ah reasons, but financial ones.

What the issues are very much depends on what business is being conducted within the unit. The concerns will be different for different products. If the Islamic unit is offering advice, then the bank must ensure, as a matter of policy, that there are clear and unambiguous Chinese walls around the individuals who have access to potentially sensitive information. Staff working in Islamic banking operations may actually have more inside information on a counterparty than their conventional colleagues, because of the partnership nature of the business relationship.

The treatment of profit-sharing and loss-bearing "depositors," the unrestricted IAHs, raises more serious and difficult concerns that are in fact even greater than in a pure Shari'ah-compliant bank. For not only do you get the questions of fairness and transparency mentioned above, but also balance sheet implications in the sense that the funds cannot be mingled with those of the bank's other activities.

This leads us to the central question about Islamic windows. To what extent should they be treated as a virtual "bank within a bank"? There are two aspects to consider – Shari'ah compliance and financial protection of consumers. There are some matters that are nothing to do with Shari'ah but are important for financial protection. I will come to those. But there are three things that are important to consider from both perspectives:

- There ought to be a set of separate accounts for the Islamic operation to provide transparency for the stakeholders. They can see how the Islamic window raises its funding and how it applies those funds. They can see that there is no commingling of funds. (This requirement is due to be incorporated in the forthcoming TMD standard of IFSB.)
- In order to manage and control this entity, there needs to be a governing body. For convenience, one can think of it as a "shadow" board of directors a body that has no legal status but has control of a segregated balance sheet. So, it ought to implement many of the governance requirements that we expect to see in a company: an independent audit committee, a structure that delivers full segregation, and a Shari'ah Supervisory Board (SSB). This need not be particularly expensive, and indeed (the SSB aside) it can simply mean using well-qualified executives from the main bank, but it can be seen as a necessary cost of establishing the firewall between the Islamic window and the other non-Shari'ah-compliant (haram) activities of the bank.
- In order to establish firewalls, a separate legal entity is best;
   it provides absolute clarity and a rigid separation of the balal

from the *haram*. Regulatory authorities in some countries (such as Malaysia) insist on this. Failing that, the Islamic operation must be able to manage its own affairs and its own balance sheet – without contagion from the rest of the bank. This enables them to apply principles of corporate governance needed for sound Islamic banking: a non-executive *Shari'ah* board; the full application of *Shari'ah* principles throughout the bank; and fair treatment of the IAHs.

These three obligations can help meet the twin demands of *Shari'ah* compliance and financial transparency. But there are also some aspects that are important to a financial regulator – such as the treatment of consumers within the Islamic window. From a financial perspective, consumers should be entitled to three things – all of which need to be embedded in the governance structure:

- IAHs are entitled to full and timely disclosure of the financial position and performance of the Islamic operation. This is to protect them against the risks described earlier – insider dealing and unfair timing differences.
- 2. They need to have the worst-case scenario explained. If the bank as a whole becomes insolvent, the legal position is unlikely to protect them even if the Islamic operation itself is healthy or if it demonstrated a profit for the investors/depositors. This may sound obvious to career lawyers or bankers, but it is not obvious to many consumers. The corporate governance structure, then, needs to ensure that risks of contagion – to or from the Islamic operation – are clear to all stakeholders.
- 3. This means an explanation of the firewalls and what they deliver in practice. The answer, as alluded to just now, is "not very much" in legal terms. The customer needs to know this, but equally to know that from a Shari'ah perspective, in the absence of the bank's failure, his dealings are ring-fenced.

So, we have a dichotomy here: from a Shari'ah point of view, it is important that the Islamic window is kept as financially separate as possible from the rest of the bank. But from the point of view of fairness to consumers, it is vital that the bank makes clear that the window is legally an inseparable part of the whole bank. That may,

of course, be a source of considerable comfort to the consumer if the bank in question is a major, well-rated international player.

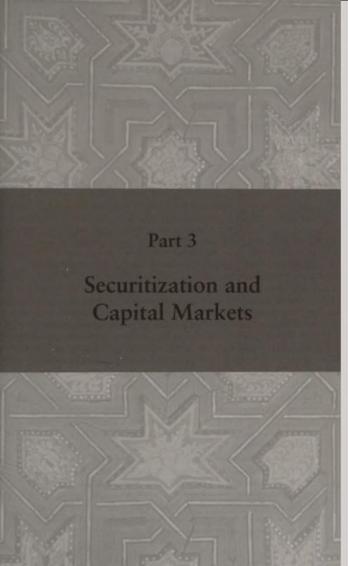
There is nothing to recommend *less* disclosure in Islamic windows than in fully Islamic banks. On the contrary, because of the need to explain the firewalls, there is arguably a need for *more* disclosure.

#### 5. CONCLUSION

This chapter has attempted to provide a brief overview of the main issues that might be expected to concern supervisors of Islamic banks. They are not trivial, but neither are they supposed to act as a barrier to progress to Islamic banking. In providing a measure of reassurance and protection to ordinary consumers in Islamic banks, sensible regulation can in fact help to bolster and maintain confidence. After all, Islamic banking is a new, exciting, and fast-growing industry – and a sound regulatory environment and well-founded public confidence can only assist the industry's growth prospects.

#### **ENDNOTES**

- For a further discussion of operational risk in Islamic banking, see Chapter 11.
- The IFSB Standard on Capital Adequacy (para. 40) proposes a 35% risk weighting for Islamic home mortgage assets, whether murabahab-based or ijarab-based, provided they satisfy substantially the same prudential criteria as those applicable to conventional home mortgages in order to qualify for this preferential risk weighting.





## Securitization in Islamic Finance

Abdulkader Thomas

### 1. INTRODUCTION

The Islamic financial market space has slowly expanded to embrace capital market activities. The attractiveness of sukuk, or Islamic bonds, has facilitated the capacity for Islamic issuers to disperse risk by moving assets off balance sheet, to diversify and prospectively lower the cost of funding, and to manage capital adequacy issues. The more complex issues of cash compared to synthetic securitization have not yet entered the Islamic marketplace, but the challenges relating to efficient securities and securitization activities are being raised in key Islamic sub-markets. In this chapter, we examine three cases in order to distinguish between securities issuance, securitization readiness, and actual securitization. In our process, we will drill through the processes and challenges to determine how the Islamic market will be able to achieve attractive tradable instruments that are properly de-recognized from the originator's balance sheet.

De-recognition ultimately turns on one of two questions: in the U.S., one asks if the originator has transferred bona fide control of the asset to a third party in exchange for consideration; and in the U.K., one asks whether or not such a transfer substantially moves all of the risks and rewards of ownership of the asset from the originator to the buyer. Successful accounting de-recognition relies upon either a sale or a "true sale." "True sale" means that one has transferred the economic value of assets from one party to another in a way that prevents the creditors or liquidator of the seller from claiming

the assets from the buyer, thus creating "bankruptcy remoteness" for the assets. Such a transfer of the "beneficial" ownership of an asset without necessarily registering a sale is permitted in Shari'ah and squares well with traditional applications of the concept of wakala, or agency. But, in Civil Code jurisdictions, which includes most Arabian countries, "true sale" is not a legal concept and might even be adjudged a form of fraud.

Such accounting and legal issues are critical to address, in particular because of the New Capital Accord (Basel II) published in June 2004 by the Basel Committee on Banking Supervision. Even if the Accord will be implemented with some diversity according to national determination, and over a fairly extended period of time, the single most important implication of Basel II is that externally rated credit exposures are normally given a more favorable risk weighting for capital adequacy purposes than unrated exposures. Consider this point solely in the light of traditional mortgage financing. In the current regulatory scheme, all home country mortgage lending is allocated a risk weight of 50% and the reconstituted mortgage loan is allocated 20%. In Basel II, the direct granular mortgage exposure will be allocated 35%, but an AAA-rated mortgage-backed security will be allocated a 7% risk weight. As a result, capital efficiency will drive banks to become more efficient managers of their balance sheets and to seek to move unrated risks off balance sheet while replacing them with comparable asset classes, but acquired as rated securities.

Therefore, banks and emerging markets as a whole have a great deal of work to do in order to prepare for Basel II. And Islamic banks and the Shari'ah-oriented markets have even more work to do. Not only does there have to be regulatory evolution, but there are Shari'ah and process risks to manage in order to assure that the securitization movement is efficiently adapted to the realities of the Islamic marketplace and the Shari'ah intellectual space.

## 2. GOLD SUKUK DMCC3

The Dubai Metals and Commodity Centre Authority (DMCC) sukuk deal, frequently termed the "Dubai Gold Sukuk" issuance, was a very clever marketing deal and widely praised as a cutting-edge sukuk issuance. This deal, however, fails the test of a securitization of assets for a number of important reasons. Let's look at the deal facts and then discuss why this securities issuance is not a securitization.

The issuer is a Special Purpose Vehicle (SPV) owned by the *sukuk* holders. The SPV and DMCC are *musharakah* partners in the underlying assets – namely, an operating account and several buildings: Almas Tower, AU Tower, AG Tower, and Jumeriah Lake Towers. None of the buildings existed at the time of issuance. The pre-construction appraised value of the buildings was United Arab Emirates Dirham (AED) 139.8 million, of which pre-construction costs of AED 29.7 million had already been spent by DMCC.

The musharakah sharing ratio is 80/20. In an ingenious approach to the question of how one either issues a fixed rate security that complies with musharakah rules or benchmarks a return to LIBOR (the London Interbank Offered Rate), the partnership will pay the excess over LIBOR plus an agreed margin to DMCC as management agent for the properties as a success or incentive fee. In other words, if the LIBOR plus margin equals an annualized 7%, based on a formula:

## LIBOR plus margin units days divided by 360.

For instance, if the rental on the properties yields an annualized gross amount of 8.75%, then 80% of the yield would be 7% payable to investors, and the manager would earn 1.75%, but no incentive. If, however, the yield were 10%, then the *sukuk* holders earn the same 7% annualized yield, but the manager would earn 3% instead of 1.75% with 1.25% representing the manager's incentive payment. And this would apply even if the annualized surplus were as great as 30% or 40%. Effectively, if the properties are sold, the incentive formula is written to assure that the *musharakah* partners – that is, the *sukuk* holders – will never participate in the upside from the sale of the properties.

In addition, there are redemption clauses, so-called puts, which also allow the *sukuk* holders to put the properties to DMCC and recover their initial investment whether or not the properties have maintained their values or decreased in value. The put is driven by defined events of default, including payment default. In the meantime, the issuer redeems certificates equal to 10% of the outstanding units each quarter in a manner that represents a 10-year amortization schedule for the five-year deal. This means that nearly 80% of the units will be redeemed by the end of the life of the transaction. DMCC further grants an "as is" purchase undertaking to buy the *musharakah* assets at term for a specific value.

Certificates are redeemable in currency or gold, but this is more of a marketing ploy and does not warrant discussion with respect to structure. More relevant to structure is the division of legal concept, All of DMCC's rights, benefits, and entitlements to the land and developments on which the buildings are to be built are transferred to a trust in a country without trust law or beneficial ownership law. Therefore, the trust is subject to English law, but the musharakah is subject to United Arab Emirates (UAE) law. This creates a complexity relating to a U.K. court granting a judgment against DMCC and the prevailing uncertainty about whether or not UAE courts would honor the U.K. judgment. For the time being, all such trust arrangements whereby rights in the UAE are transferred to foreign investors - that is, sukuk holders - are granted an exemption from existing laws by the Ruler of Dubai. As of this writing, a trust law has been introduced in the Dubai International Financial Centre and such an exemption may no longer be required for future sukuk issuances in Dubai. The exemption should help to overcome conflict of law issues, which have never been tested. A key challenge is that the buildings themselves are not transferred. Under local UAE law the strongest protection offered to the sukuk holders is a negative pledge by DMCC.

If one simply looks at three key concepts – true sale, determination of who has preponderate risk and rewards, and determination of who has control of the assets – one may understand clearly whether or not this is a debt securities issuance or an asset securitization.

The UAE is a civil code jurisdiction applying a variation of the Egyptian jurist Abdul Razaq Sanhuri's adaptation of the Franco-Swiss civil code in which Shari'ah is "a source of law." As a result, true sale is not an established concept in law. This means that the sale of rights, benefits, and developments is not necessarily recognized outside of the fee simple sale of property or the lease (a sale of manfa'a, or rights and benefits in property). Unlike some musharakah deals in which the property is implicitly leased, this is not crafted as a lease. Therefore, in English law, the trust may appear to have achieved assets by true sale; but judgments flowing from this understanding may not be upheld in the UAE where neither a fee simple sale nor a lease has taken place between the issuer and DMCC (although DMCC is a tenant in one or more of the buildings).

If true sale has not taken place, then who has the majority of risks and rewards? DMCC. The high degree of amortization, as well as the put and purchase undertakings, ensures that DMCC has all of the property-related risks in the buildings. DMCC is the only party

structured to lose money if a building is sold at a loss or fails to perform, and DMCC is the only party that can ever profit from a capital gain. Therefore, the overwhelming majority of the risks and rewards belong solely to DMCC and not the issuer.

Beyond control of the risks and rewards, DMCC has registered title, occupancy, and the agency to manage the property. The trustee appears to have limited rights to interfere in property-level activities. As a result, DMCC does not appear to have relinquished control of the assets.

Before continuing, none of these business points invalidates the concept of *musharakah*. The tradition of *musharakah* is very flexible and does not require accounting de-recognition or true sale. Therefore, these questions point solely as to whether or not there is a proper asset securitization. And, in reality, there is not. This is a debt-like partnership, which has issued securities.

## 3. THE INVESTMENT DAR

If the Gold Sukuk DMCC is not an asset securitization, then what of the declining balance partnership securitization for The Investment Dar (TID) which also closed in 2005? This deal, which ultimately raised US\$100 million, was applied to fund the acquisition of goods for sale or lease to TID retail clients as well as some existing assets on TID's balance sheet.

The funds raised were commingled with TID funds to buy new and existing assets through the issuer as buying entity. TID would act as the manager for the sale or lease of the assets, and as servicer to collect payments. Over that time, TID committed to buy out the units of the other investors in the partnership that is the issuer.

Following our review model as applied with the Gold Sukuk DMCC, one benefits from a brief analysis of how well TID meets the three key tests identified above. Like the UAE, Kuwait is a Sanhuri civil code jurisdiction in which Shari'ah is "a source of law." As a result, true sale is as problematic in Kuwait as in other civil code jurisdictions. But, in this case, two steps will take place under Kuwaiti law. Foremost, TID transfers receivables to the partnership. And the partnership purchases new personal property, which it owns until TID either sells it or terminates the underlying lease. Since Kuwait permits the transfer of debts, the true sale question is avoided. Moreover, since the partnership buys assets, one does not worry about how the assets move from TID to the partnership.

If true sale can be avoided as an issue, what about accounting recognition? Who has the majority of risks and rewards? TID. Just like DMCC, TID has given a purchase undertaking, this one structured with a similar fixed buyout. TID is the only party structured to lose money if the assets are sold at a loss or suffer harm. Like DMCC, TID has agreed to a formula that delivers a LIBOR plus 200-basis-points return to its partners and conveys an incentive to the manager, TID. As a result, it seems that the majority of the risks and rewards belong to TID and not the issuer.

Beyond control of the risks and rewards, TID has possession and registered title, and manages the sales/leasing process as well as the collections cycle. The partners have limited rights to interfere in the asset transaction activities. TID appears to have significant control of the assets.

As with DMCC, this is not challenged as a true Shari'ah-compliant declining balance musharakah. Rather, the process seems to imply that movement of the assets would likely require their recognition as assets of TID and not uniquely of the partnership. This means, then, that the TID deal is not a proper asset securitization. And, in reality, it is a debt-like amortizing partnership that has issued securities.

## 4. PROFIT-SHARING CERTIFICATES5

In the United States, University Bank of Michigan operates an Islamic subsidiary, University Islamic Financial Corp. (UIFC). Although there are both civil code and common law jurisdictions at the state level, federal law is common law-driven. Michigan is also a common law jurisdiction. UIFC has Federal Deposit Insurance Corp. (FDIC) permission to operate a profit-sharing investment account (PSIA) programme that it terms to be a profit-sharing deposit. The sole assets for this programme are sukuk al ijarah generated by the UIFC ijarah mortgage alternative<sup>6</sup> programme. Effectively, the PSIA acts like a warehouse for securitization-eligible instruments, holding them until they are sold to long-term investors. Despite the musharakah features of these PSIA deposits, they are defined as deposits in a private ruling by the FDIC.

UIFC offers several mortgage alternative programmes. The longestrunning is based on *ijarah*. In this programme, a consumer identifies a property and UIFC establishes a trust to buy the home. The trust is independent, and UIFC's role as trustee is fiduciary for all trust beneficiaries. This means that UIFC has a higher duty to the interests of the beneficiaries than it does to itself: violation of fiduciary roles is punishable by prison and large fines. The trust is a unique entity and independent of UIFC and its parent bank.

The trust executes the purchase of the property, and UIFC funds it by purchasing a sakk al ijarah (sakk is the singular of sukuk). The sakk, which is transferable or salable, represents the beneficial ownership of the house that is being leased. The holder has recourse only to the house; so if UIFC sells a sakk to depositors in the PSIA programme, then the depositors technically have no put to UIFC if there is a default, and UIFC's parent simply acts as servicer for payments, collections, and default management.

As of now, UIFC has not sold the certificates to any third-party investor. Therefore, the deposits are a warehousing programme in which UIFC will agree to buy back certificates and replace troubled certificates. They are securitizable, but not a securitization. Again, with the Gold Sukuk DMCC review model, we are able to determine if the UIFC sukuk pass the true sale, preponderance of risk and reward, and control tests.

UIFC presents us with our first common law case in which Shari'ah has no official or formal influence. There are no issues with beneficial ownership through a trust; no challenges to the originator serving as a fiduciary trustee. The assets originated by UIFC are genuinely owned by the trust. But, UIFC is the beneficial owner of the property, and the conveyance to the PSIA holders is subject to a number of FDIC conditions that create an informal put back to UIFC. Therefore, there is no true sale to the PSIA holders. But, were the sukuk sold to a third party without any form of put or conditionality, the sale would qualify as a true sale.

With respect to the PSIAs, the FDIC conditionality means that the risks to the PSIA holders are less than the rewards, whereas the risks to UIFC as well as the rewards may also be weighed in favor of UIFC. But the sukuk are designed as Uniform Commercial Code Article 9 Lease Instruments. Therefore, if the trustee were to transfer the sukuk to any third party, without conditionality, in such a case, the risk and rewards of ownership could be transferred in full to the investor, meaning that the investor would truly have all of the underlying risks and rewards.

Beyond control of the risks and rewards, the sakk represents solely the underlying property and its rental. Whoever holds the sakk has control of the investment subject to the conditions of the trust indenture and any underlying contracts such as the lease of property. In the PSIA relationships, the structure of control lies in the trust and contracts, but the management of *sukuk* process rests with UIFC.

The best conclusion with the UIFC instruments is that they meet the criteria for securitization, but they have not been securitized through their placement in the PSIAs.

#### 5. CAGAMAS

Cagamas might be described as the Malaysian equivalent of Freddie Mac or Fannie Mae. This AAA-rated government-sponsored entity, 20% owned by Bank Negara, issues securities backed by residential housing obligations in Malaysia. Up until now, Cagamas has been primarily a conventional entity, but it has introduced a murabahah product under the Malaysian approach of bai bi thamin al ajil (BBA) and an ijarah product. The former have been securitized domestically; the latter have not yet been securitized. Without opining on the difference of opinion between Malaysian scholars and others relating to sale of a debt created in a murabahah transaction, in this segment we look into the Cagamas process.

Cagamas will buy murabahah (termed BBA if long-term) receivables from banks applying a standard form of BBA for residential transactions and meeting specific underwriting standards. The only residual risk with the bank selling the debt is a default, fraud, or error clawback. In other words, the seller of the debt would only be obliged to take back an asset if there is any act of fraud, or if the underwriting of the underlying credit is found to be incorrect. Likewise, Cagamas has a put back right to the originator if the underlying obligor defaults, and some analysts claim this is not true securitization<sup>8</sup> although it is a direct parallel of the Freddie Mac and Fannie Mae securitization practice.

On February 26, 2006, Cagamas bundled its second universe<sup>3</sup> of murabahab receivables and transferred RM1.2 billion (approximately US\$320 million) to the issuer. The securities were tranched in three batches: RM500 million of two-year, RM200 million of three-year, and RM500 million of four-year pass-through obligations called Cagamas Bithaman Ajil Islamic Securities (BAIS). The securities are full-faith unsecured obligations of Cagamas.<sup>10</sup>

There is no challenge under Malaysian law, which embodies the common law, to establish a trust. When operational, the trust is the true owner of the assets on behalf of the securities holders.

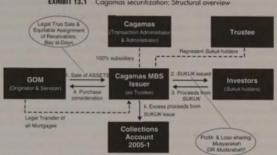


EXHIBIT 13.1 Cagamas securitization: Structural overview

Note: Musyarakah is the Malaysian spelling of musharakah.

Source: Rafe Haneef, "RM2.05 Billion Islamic Residential Mortgage-backed Securities (Sukuk al-Musyarakah)," presented at the Islamic Banking Conference, Karachi, Pakistan, September 15, 2005.

Neither Cagamas nor the underlying originators (in this case, the Government of Malaysia, which sold murabahah receivables relating to the mortgaging of homes for government employees to Cagamas) have control or the preponderance of the risks and rewards: these have passed to the investors for the life of the transaction. The flow of the assets from the originator to the issuer, and the roles of the parties, are set out in Exhibit 13.1.

If one simply looks at three key concepts - true sale; determination of who has preponderate risks and rewards; and determination of who has control of the assets - one may understand clearly whether or not this is a debt securities issuance or an asset securitization. Like Michigan and the U.S., Malaysia is a common law jurisdiction. Thus, the civil code and Sanhuri challenge is not a problem. True sale is an established concept in law. Trusts as a means of isolating asset ownership from originator ownership and bankruptcy are common, and Malaysia already enjoys a vibrant asset-backed securities market applying sophisticated applications for true sale and beneficial ownership.

Although true sale has taken place, there remains the question of who controls the majority of risks and rewards in the Cagamas asset sales. The originator remains a servicer and is paid a fee. But, in the absence of default, fraud, or underwriting errors that fail an audit,

the originator has no ongoing asset-level risks. Therefore, the assets may be de-recognized by the originator. Cagamas places a wrap on the universe of assets, but the risks and rewards are weighted toward the investor. Nonetheless, the fact that these are full-faith and credit general obligations of Cagamas means that these assets ultimately remain in the control of Cagamas, especially since the securities have a shorter term than the assets (unlike many Freddie Mac and Fannie Mae instruments).

Beyond control of the risks and rewards, the trust that purchased the assets holds beneficial title for the end-market investors. The trust indenture gives the trust control of all critical decisions and the capacity to direct the servicer in the event of contractual faults or payment defaults under the transferred assets. Therefore, control has moved away from the originator, and during the term of the securities, from Cagamas.

Thus, despite the asset transfer being subject to clawbacks, the Cagamas securities issuance is a true securitization of the underlying housing debts so far as the originators are concerned. With respect to Cagamas, the ultimate securities are more in the nature of pass-through securities and less of a true independent securitization.

### 6. CONCLUSIONS

The Islamic finance space is rapidly embracing new opportunities and methods in order to serve core clients better. But these developments must ultimately lead to business activities that are more consistent with the demands that will require more active balance sheet management than has ever been pursued by Islamic banks in the past. To move from periodic securities issuances, originators must have the capacity to generate replicable asset universes with common characteristics; they must have business with scale.

Securitization relies upon true sale – movement of ownership between parties without necessarily moving title or physical locus. This should result in accounting de-recognition, shifting the elements of ownership in bankruptcy from the originator to the investor. As we saw with Gold Sukuk DMCC, it is questionable whether the assets may truly be de-recognized or if any form of true sale has taken place. A similar situation applies to TID, which follows some of the steps required in a securitization. But, TID provides recourse in a substantive way preventing de-recognition.

The UIFC and Cagamas cases, however, demonstrate originators capable of achieving scale and uniformity. In both cases, the local law allows for true sale and the assets may be moved from bank balance sheets, allowing bank originators a clear means to manage capital and credit risks under the Basel II guidelines.

What makes a tradable instrument with an attractive yield? A security that has predictable characteristics, reasonable income, and for which data may be built up. And one that is properly de-recognized from the originator's balance sheet, allowing for bankruptcy and legal remoteness from the originator. In the Islamic market, such a security needs regulatory action.

Not only does there have to be regulatory change and legal updates in all codes; there must also be greater clarity about the *Shari'ah* process. Updates involve clarity over the concept of true sale and resultant de-recognition and bankruptcy remoteness. Moreover, issues relating to the character of an SPV and how it functions in *Shari'ah* compliance need to be refined and updated – particularly, with respect to bankruptcy.

#### **ENDNOTES**

- The International Accounting Standards Board's IAS 39 sets out de-recognition criteria that involve transfer of the risks and rewards of ownership and (if some, but not substantially all, of these have been transferred) transfer of control.
- <sup>2</sup> Patrick Clancy, "Legal Structure of Cash and Synthetic Transactions," in Rick Watson and Jeremy Carter, Asset Securitisation and Synthetic Structures: Innovations in the European Credit Markets, Euromoney, London, 2006, p. 40.
- Data derived from Gold Sukuk DMCC Red Herring Offering Memorandum dated April 5, 2005.
- 4 Based on The Investment Dar term sheet posted at www.securities.com/ifis.
- The author's firm, SHAPE<sup>TM</sup> Financial Corp., is an advisor to University Islamic Financial Corp. and licensor of both narah mortgage alternative products and profit-sharing deposit technology, SHAPE<sup>TM</sup> Financial Corp. is the sole owner of a Federal Deposit Insurance Corporation private letter ruling governing Islamic deposits in the U.S. which is ratified in practice at UIFC.
- <sup>6</sup> We call this a "mortgage alternative" because it helps a consumer to acquire a home, but there is no mortgage instrument involved in the transaction.
- 7 Loic Chiquier, Liquidity Facilities in Emerging Economies: Housing Finance in Emerging Economies, presented at the World Bank, March 10–13, 2003. Purchases of instruments have put-backs to originators with periodic review periods.
- Minutes of the second meeting of the Asian Bond Market Study Committee, June 7, 2004 at the 1st special conference room (No. 306), Ministry of Finance, Japan, p. 39.

<sup>9</sup> Rafe Haneef, "RM2.05 Billion Islamic Residential Mortgage-backed Securities (Sukuk al-Musyarakah)," presented at the Islamic Banking Conference, Karachi, Pakistan, September 15, 2005. The first issuance closed in July 2005.

10 Issuance of Cagamas Bithaman Ajil Islamic Securities (BAIS), posted at Cagamas Berhad, February 24, 2006, www.cagamas.com.my/caga-docs/html-dir/news.html

#CagaBAIS.

# The Role of Capital Markets in Ensuring Islamic Financial Liquidity

Stella Cox

#### 1. INTRODUCTION

This chapter is focused on the importance of liquidity in the Islamic financial marketplace. As well as conducting a brief review of some preferred liquidity management tools, it will examine the structural issues that have impacted the formation of the Islamic capital and interbank markets and the challenges that persist, and will consider how these have been, and could still be, addressed.

# 2. CHALLENGES OF ISLAMIC FINANCIAL OPERATIONS

Whatever the financial requirement, a multitude of investment and funding products are available within the mainstream financial sector. Ability to access them is taken for granted. Within the Islamic financial sector the situation is somewhat different.

Religious jurisprudence has historically excluded Islamic banks from the natural benefits of mainstream financial practice, such as recourse to the institutional money markets, debt capital markets, and, according to general perception, a lender of last resort. Despite this, Islamic banks have had to conform to regulatory stipulations more commonly applied to an interest-based banking environment. They have been required to comply with mainstream capital adequacy and

liquidity ratios and have had to find alternative, Shari'ah-compliant solutions to the deposit reserve requirement.

# 3. CREATING A SHARI'AH-COMPLIANT ASSET BASE

Islamic financial sector products are asset-based. One of the fundamental principles has been that money must be productively deployed for economic benefit. Investment should therefore be effected through physical ownership of tangible assets with an income stream that may be attributed to the economic use of the asset. Since the 1970s, Islamic banks have been increasingly successful in their domestic markets, and product innovation has largely been engineered to meet their specific investment risk and return criteria.

Previously, there has been no Shari'ah-compliant alternative to the interbank or capital markets. Maintenance of a matched balance sheet is the practised art of the Islamic bank treasurer. The murabahah contract has dominated both the allocation and utilization of short-term liquidity. A review of the audited financial statements of many Islamic banks reveals that, regularly, more than 65% of the balance sheet is still allocated to investments of this type.

## 3.1. Murabahah: Asset or Limitation?

In both murabahah and the similarly constructed al bai bithaman ajil contract favored in Malaysia, the underlying asset is purchased and sold at inception with deferred payment consideration. Critics of murabahah have harbored concern that dependence on the contract has impeded development of other Sbari'ah-compliant instruments that might be better placed to provide for deployment of interbank liquidity.

On the other hand, if we stop for just a moment to consider the various customer and regulatory demands placed upon Islamic banks, perhaps it helps us to balance the argument. What would happen in the mainstream financial environment if the international money markets became inaccessible for a week, or even a day? The market would probably collapse. Without recourse to such liquidity the Islamic banks have managed to exist, grow their client base, make profit distributions, and satisfy their local central banks, but to achieve all of this simultaneously they have been obliged to maintain an exceptionally high level of liquidity at all times.

## 3.2. Islamic Debt Securities (Bai Al Dayn)

The Malaysian market has developed a procedure for securitization of the *al bai bithaman ajil* contract, but the resultant *bai al dayn* securities (sometimes referred to as Islamic debt securities) have proven contentious in the Arab world. Outside of Malaysia, the majority of *Shari'ah* scholars concur that any further trading in the income stream will be trading in debt, because the receivables are no longer directly attributable to an asset to which the investor retains beneficial title.

#### 4. CREATING LIQUIDITY - IJARAH

Ijarah has long been the preferred contract for offering medium-term, asset-based finance. An ijarah contract incorporates a fixed-term, or periodically re-fixed, income stream, or rental, from the economic use of a physical underlying asset. Lease income streams can also be readily securitized without the infringement of Shari'ah, because the investor retains title to the leased asset (or a part thereof) throughout the investment period.

Ijarah funds have been incorporated to capitalize on a broad spectrum of international investment opportunities. Funds tend to invest in pools of suitable leased assets, which may be sold to a special purpose vehicle owned by the fund. The fund manager may choose to evidence holdings to investors by issuing certificates that represent their ownership of, or title to, a percentage of the asset pool and, thereby, a pro-rata share of the income stream.

Historically, the investment exit strategy has been underwritten by the product sponsor, who will acquire asset holdings from the investor or arrange asset sales on a "best effort" or matched basis. Among the first to implement the concept was the Islamic Development Bank. Mindful of the liquidity issues facing Islamic banks, its bank investors were given the right to redeem their funds by selling their holdings to the sponsor.

## 4.1. Short-term Investment Programmes

Undoubtedly the long-held aim of some of the larger Islamic lease funds has been the securitization and subsequent trading of the asset portfolio within a regulated market environment. Product sponsors have grappled with the challenges of obtaining regulatory approval and the prospects of achieving international ratings, but in the absence of an established Islamic market infrastructure it has been impossible to move speedily.

There has certainly been progression. Some years ago, Arcapita Bank in Bahrain launched an Islamic *ijaqah* liquidity programme. The programme's objectives are to preserve investment capital, to provide consistent income, and to offer institutional investors returns comparable to those available through the traditional money markets.

Investor funds acquire a percentage of ownership of a leased asset pool acquired by a subsidiary of Arcapita. Uncertified securities, or sukuk, are issued to investors, confirming their fractional ownership interests in the underlying assets. The investor is granted a put option enabling the sukuk to be put back to a third-party liquidity provider. The put can be effected at the sukuk face value on any redemption date after a minimum one-month holding. As it is underwritten by a third-party bank bearing a top-tier, short-term rating from the major international rating agencies, it offers an interesting bank risk alternative to secured murabahah.

## 4.2. Overnight Investment Programmes

Many of the arrangements developed for the placement and utilization of Islamic liquidity have originated from bespoke financing rather than capital market structures. As a result, operational and settlement procedures can be cumbersome and short-dated products are in limited supply. Various institutions offer overnight murabahah structures on an accommodation basis, but there is no Islamic alternative to conventional market solutions. To date, the only product in our market that has consistently offered an overnight solution has been ABC Islamic Bank's Islamic Fund and Clearing Company, ABC offers investment units, supported by a blend of trade and leasebased assets, pooled to generate overnight investment opportunities. Buyback of units can also be secured through a guarantee issued by the ABC parent bank, and that bank rating is very useful for satisfying certain interbank, or indeed regulatory, counterparty limit stipulations. Otherwise, it has proven incredibly difficult to create a Shari'ah-compliant overnight product that has the right risk/vield profile. Products have been launched, proven commercially unviable and been withdrawn, and others are being developed. Given the huge demand, and therefore the potential, the lack of origination of suitable product demonstrates how tough the task has proven.

#### 5. ISLAMIC GLOBAL FINANCIAL ASSETS

Accelerating the origination of instruments that will underpin Islamic financial-sector liquidity is always central to our industry debate, and the previous examples were intended to offer an illustration of products that have supported the allocation of interbank liquidity. While providing valuable allocation opportunities, these are obviously independent initiatives that did not set out to replicate a formal, interbank environment, but that is more or less what has happened due to the constant increase in liquidity volumes and the pressure on institutions to seek efficient allocation of funds.

In early 2006, research conducted by Islamic Finance Consultants in Bahrain estimated that Islamic financial assets today are in aggregate some US\$400 billion. Of this, liquid assets account for US\$30–US\$50 billion. Research findings also suggest that approximately 20% of liquid assets are allocated to investment fund products.

In recent years, Islamic investors have sought allocation opportunities in the mainstream global markets. Although performance of individual asset classes may have been volatile, the experience and linkage with procedure, practice, and stipulation within established and regulated market environments has proven to be of great educational value.

# 6. FORMATION OF THE ISLAMIC FINANCIAL MARKETPLACE

The traditional dependence on bilateral structures for the deployment of interbank liquidity has enabled the preferences of individual institutions to dominate practice. It has adversely impacted the speed of development of standardized products and systems, which have proven difficult to advance without consensus and consistency of opinion among the esteemed *Shari'ah* authorities and, of course, the Islamic banks themselves. Although there is no doubt that the Islamic financial sector needs, and its participants want, the market to evolve, establishing sufficient numbers of founder participants willing to invest in it, and support it, on comparable terms has not been easy. Strong and, ideally, centralized regulation has always been a prerequisite and, for many years, there were unanswered questions as to who might provide it.

The Islamic world is extremely diverse and the emergence of its financial marketplace has always been dependent not only upon the satisfaction of *Shari'ah* stipulation at a very broad level, but also on the ability to accommodate the regulatory and financial accounting standards of jurisdictions stretching from the Middle East, to Africa, Asia, and beyond. Previous attempts at formalizing the market environment have been sporadic.

## 6.1. The Islamic Financial Infrastructure

Recent, new direction has resulted from international cooperation and shared intention to deliver. In 2001, the Bahrain Monetary Agency (BMA) signed a Memorandum of Understanding with the Islamic Development Bank and the Labuan Offshore Financial Services Authority (LOFSA), Bank of Sudan, and Brunei Ministry of Finance to support the establishment of the Islamic capital market. As a result, the multilateral International Islamic Financial Market (IIFM) is now headquartered in Bahrain, to provide a cooperative framework for the market infrastructure.

The Liquidity Management Centre (LMC) was established by its founder shareholders, Islamic Development Bank, Kuwait Finance House, Dubai Islamic Bank, and Bahrain Islamic Bank. The LMC has taken a proactive role in the sukuk issuance programme and will transfer its focus to developing its market-making capability as volumes grow. Bahrain is also the headquarters of the International Islamic Rating Agency, established to bring consistency to the rating of Islamic financial instruments. Finally, the Islamic Financial Services Board (IFSB), hosted in Kuala Lumpur, has been established to centralize the setting of prudential standards for the regulation and supervision of Islamic banking. The IFSB has recently formed a Task Force comprising regulatory authorities, the IIFM, and market participants to build consensus and harmonize approaches across boundaries on the design and development of markets for Shari'ahcompatible short-term financial instruments. The Task Force will focus on monetary operations of central banks as well as liquidity management of Islamic institutions, and encourage and assist the integration of domestic Islamic money markets into the broader international financial system.

There are still issues to resolve, but it seems that the foundations of the market are finally in place and, during the past five years, much has been done to address the perceived structural and regulatory inadequacies of the past. However, the establishment of a fully functional, Islamic market infrastructure has also required the proactive involvement of the jurisdictional regulators relevant to Islamic financial practice. The visible participation and support of Arab and Southeast Asian authorities in innovating and promoting issuance of Shari'ah-compliant, tradable instruments has enhanced market profile and the likelihood of sustaining liquidity as the system matures.

## 6.2. The Regulators

## Bahrain Monetary Agency

Encouragingly, the regulatory authorities perceived as being most relevant to the Islamic financial marketplace are individually becoming increasingly involved in it. In addition to sponsoring or hosting the multilateral institutions referred to previously and promoting the integration of global Islamic financial standards, the BMA has been proactive in the development and issuance of sukuk. Its own issuance of short- and medium-term paper crossed the US\$1 billion mark in 2004 and has been a valuable channel of allocation for surplus bank liquidity.

## Bank Negara and the Securities Commission, Malaysia

Malaysia has not only implemented a dual banking system, it has successfully integrated its conventional and Islamic financial infrastructures and issued formal regulatory standards for its Islamic interbank and capital markets. Admittedly its systems are indigenous and not fully accepted in other jurisdictions, but in late 2005, both Malaysia and Singapore made provision, through legislative changes, to support the development of products and structures more relevant to the Arab Islamic marketplace.

## Dubai International Financial Centre

Although the Dubai International Financial Centre's (DIFC) own formation was announced as recently as 2002, it deems Islamic finance to be one of its six "pillars" and has issued draft regulatory standards for Islamic financial practice. During 2005 it achieved a number of its objectives. Among them was the inauguration of its own Islamic Advisory Committee announced by the Dubai Financial Services Authority and the listing on the Dubai International Financial Exchange of several Shari'ab-compliant indexes.

# 7. ENSURING LIQUIDITY IN THE ISLAMIC FINANCIAL MARKETPLACE

We work in a diverse and rapidly expanding, cross-border marketplace. Research suggests that more than two-thirds of Islamic liquidity is from the Middle East, but established and accepted structures for the allocation of that liquidity must be supplemented, and indeed improved, by delivery of opportunities and products that are more broadly acceptable to a wider marketplace. While meeting the needs of the Islamic institutional community is the first priority, there is no reason why new innovations and instruments should not appeal and offer diversification to mainstream financial participants, too. Ultimately, this will assist with the adoption of standard protocols by the market.

### 7.1. Tawarrug

The development of tawarruq-based products has been a strong initiative of recent years. Previously, Islamic institutions have, as discussed earlier in this chapter, allocated short-term liquidity through bank-secured murabahah transactions. Reciprocal requirement has often been dependent upon reverse murabahah solutions provided by bank counterparties from the international markets.

In a new era of cooperation, the major Islamic banks are exerting greater direct control over the management of their own liquidity. Spot value purchases and sales of commodity-type assets between Islamic institutions are supporting the facilitation of wholesale, Shari'abcompliant, interbank transactions. The Islamic banks interface as direct counterparties with asset brokers, merchants, and each other, thereby avoiding unnecessary and costly intermediation by third-party agents. Further structuring developments have enabled tawarrugbased financing products to be offered at retail level by a growing number of Islamic and Arab banks. Such has been the growth and demand for the structure, that our esteemed scholars have been called to review its merits. Previously the OIC Figh Academy in Jeddah called for a full procedural and structural review and it has been stipulated that the structures must provide for parties to act as principals, rather than through agency arrangements, so as to assert direct control over assets and cash flows. Accordingly, the procedures for execution of the contract have been further defined, but it is to be hoped that we can establish parameters for ongoing activity with full Shari'ah endorsement. Although new to the market, already we have

seen unprecedented levels of standardization in the operational and administrative procedures that support delivery of this product and it has served to facilitate dependable liquidity. This is an achievement, in itself, as structural stipulations mean that there is no place for intermediaries as might normally be taken for granted in a cash market environment.

## 7.2. Issuance of Liquid Instruments

Undoubtedly sukuk issuance needs to accelerate considerably before it can claim to offer market recourse to liquidity. Despite the current focus on sovereign and quasi-sovereign issuers, the role of individual Islamic banks is also crucial. They have all-important credibility in their domestic environments, plus the size and scope to anchor market initiatives. Arcapita Bank launched its US\$75 million debut international sukuk in 2003 to finance the expansion of its European operations. Since then the bank has returned to the market with a Euro 76 million, two-year sukuk in 2004, and in October 2005 it followed with a five-year combined Euro 46 million and US\$155 million murabahah notes-backed sukuk. Distribution has targeted the Islamic and mainstream banking sectors and, importantly, this is one of the first examples of an Islamic institution utilizing the capital market regularly, rather than for single, headline transactions, and thereby assisting with the volume-building process.

International banks have certainly played their part in the development of Islamic financial services, and it appears that their commitment will extend beyond proprietary investment services and a desire to lead manage the new Islamic bond issues. Their substantial balance sheets and long-term market experience can be harnessed to underwrite market liquidity as the market-building process accelerates.

### 7.3. Distribution of Islamic Securities

The recent issuance of a range of sovereign and quasi-sovereign sukuk has also started to address this requirement. The undoubted strength of the sponsors, the comfort derived from internationally recognized rating endorsements, and, to date, the premium on return over comparable risks in the international marketplace have been very positively received by investors and the take-up by both Islamic and conventional banks has been significant.

The Islamic Development Bank's debut international sukuk raised US\$400 million and was awarded an AAA rating by Standard & Poor's (a first for an Arab issuer). The IDB sukuk asset pool combined 49% murabahah receivables and 51% leased assets, deemed acceptable for secondary trading from a Shari'ah perspective because the weighting favored the lease-based contracts. IDB acknowledges that a principal objective was to familiarize the international capital markets with the structure, and 70% of the issue was placed with conventional, institutional investors.

Although issues are being listed to pave the way for secondary trading, there is still some concern about the lack of liquidity presently. It is certainly true that *sukuk* are not really being traded, but the market was starved for so long of high-quality paper that many Islamic institutional investors have, thus far, been purchasing to hold. Movement in this position is likely to be prompted by increasing market volume, the natural tightening of yields as the commercial features of issues become more correlated to mainstream markets, and the motivation of investors that seek to trade and profit from capital market activity.

It is important to develop a trend of continued issuance if the market is to evolve. To date, sovereign issuance has largely been confined to single, significant issues. This is useful for building investor confidence and establishing structural reputation, but the continuity that is seen from the BMA's repeated issuance, Arcapita's series of transactions, and the recurrent issues envisaged through the IDB's medium-term notes programme (Shari'ah-compliant trust certificates) is critical and will help to encourage corporate activity, which is still in relative nascency.

#### 8. CONCLUSION

During this chapter we have considered the practices and procedures that have evolved, and the infrastructure that is still evolving, to support Islamic interbank activity. What is clear is that Islamic financial practice is cross-border and has consolidated its links with global opportunities. However, the dynamics of the market are changing. The regional Arab markets were buoyant throughout 2004 and 2005 and we have witnessed unprecedented capital market activity, with initial public offerings dominating investor focus. These have certainly altered established Islamic institutional liquidity trends and heightened the importance of maintaining sufficient daily liquidity flows.

The Islamic financial infrastructure has been greatly strengthened by its four new multinational institutions, and its internal asset origination capability has matured significantly during recent years. Improved cooperation, dialogue, and direct interaction between the major Islamic institutions is enhancing their own contribution and beginning to create new levels of product standardization and market innovations.

There is some frustration within Islamic finance that the infrastructure is incomplete and the secondary market still lacking, but this is a natural part of market development while the volume-building process gathers momentum. At this stage, strong origination and continued issuance of quality products and instruments are key to reinforcing the foundations. Priority consideration must be given now to the establishment of a centralized, market-accessible hub for settlement and clearing. Presently, bilateral settlement is a feature, and recourse to a central counterparty will be essential to any market platform. The absence of such a facility will serve to suppress the natural development of secondary trading and preclude the Islamic marketplace from the benefits of ever-improving financial services technology.

Successful markets thrive on substance and security. An infrastructure created through standard market practice and secure settlement, supplemented by effective supervision and strong regulation, within an established legal framework, helps to prohibit erratic behavior by participants as well as serving to comfort them. Transparency is critical, and independent rating endorsement allows objective assessment, which, again, develops investor confidence. In turn, market confidence injects the liquidity to help achieve the critical mass that any financial market needs to function efficiently.



# Regulating Islamic Capital Markets

Robert Gray and Arshad Ismail

The Islamic finance industry has seen phenomenal growth in recent years and the indications are that it will continue to grow at a rapid pace. There are many reasons for this growth. The establishment of the Islamic Development Bank in 1974 was a very important step in the history of the development of the Islamic finance industry. The establishment of several Islamic banks in the United Arab Emirates, Egypt, Sudan, Kuwait, and Jordan followed in the second half of the 1970s. The 1980s saw Malaysia's entry into the industry, and over the past 20 years it has succeeded in developing a vibrant Islamic finance market.

Since Islamic finance itself is, in relative terms, a new industry, it is not surprising that the capital markets segment in the broader Islamic finance world is relatively underdeveloped. The need for dynamic and efficient capital markets in the Islamic finance area cannot be over-emphasized. Islamic finance can only claim to be a fully-fledged financial system when its capital markets have the depth and liquidity typically found in conventional markets.

The focus of this chapter is the regulatory aspects of the Islamic capital markets. The question of how much regulation is required will be discussed. Particular attention will be paid to those jurisdictions that have some history of regulating Islamic capital markets. The question of how the parameters of Islamic capital markets regulation differ from conventional market regulation will also be discussed.

# 1, HOW ARE ISLAMIC CAPITAL MARKETS BEING REGULATED?

The world's most advanced capital markets are to be found in the United States, Japan, the European Union nations, Canada, and Australia. Although none of these markets has an Islamic finance sector of any significance, the legal and regulatory environment in these jurisdictions is not necessarily unfriendly to Islamic finance. For example, the concept of equipment trust certificates is well recognized under the laws of New York and is generally in line with the generic sukuk structure. By the same token, most of the major sukuk transactions to date have been documented in line with English law. These include the sovereign sukuk transactions for Malaysia, Oatar, Dubai, and Pakistan. English trust law has been found to be more than adequate to support the issuance of sukuk even though the concept of sukuk is not given specific legal recognition under English law: issuers, lead managers, and investors have been comfortable with the protections it affords. Furthermore, all the mentioned sukuk have been listed on the Luxembourg Stock Exchange under the applicable rules and regulations for listing securities.

The question that arises is how much regulation is needed for Islamic capital markets. Where the existing regulatory framework (as briefly discussed above) seems able to support the issuance of Islamic securities, is there an argument for relying on said framework instead of formulating fresh regulations designed to cater specifically to Islamic securities?

In the case of Malaysia, a systematic initiative was launched to provide a conducive legal and regulatory environment for Islamic finance. Malaysia is a good case study for Islamic securities and their regulation. The Islamic finance industry in Malaysia officially commenced with the enactment of the Islamic Banking Act 1983. The Act regulates "Islamic banks," which are defined simply as banks licensed under the Act. The Act does not go into detail on what constitutes Islamic banking or finance business; it simply states that it is banking or finance business that is not prohibited under Shari'ah. The Act also makes it compulsory for any bank licensed under it to have a Shari'ah board to advise it on its business and operations to ensure compliance with Shari'ah.

Bank Islam Malaysia Berhad was the first bank to be licensed under the Act and it was the only Islamic bank in Malaysia for almost a decade. The approach taken by the authorities was interesting in that they merely provided a platform for Islamic finance but did not dictate what the business should be or how it should be run. With the benefit of hindsight, this was perhaps the best approach as it allowed industry players to gauge the market and react accordingly, instead of being subject to a fixed set of rules or objectives.

The Islamic capital markets in Malaysia have enjoyed a strong pattern of growth. The first Islamic capital market transaction was concluded in the early 1990s based on rules and regulations that were not specifically tailored to Islamic securities. Subsequently, the issuance of Islamic securities was governed by the "Guidelines on the Offering of Private Debt Securities" issued by the Securities Commission of Malaysia. These guidelines governed the issuance of both conventional securities and Islamic securities. The bulk of the guidelines was applicable to both types of securities, although there were additional guidelines that applied specifically to Islamic securities requiring in particular the appointment of a Shari'ah advisor to advise on the issuance of Islamic securities. The Shari'ah advisor appointed must be selected from a list of approved advisors issued by the authorities. The guidelines also set out several approved Shari'ah concepts and principles for structuring and issuing Islamic securities.

This approach has worked very well in the Malaysian market. In essence, there was little difference, from a regulatory perspective, between Islamic and conventional securities. However, a deeper examination of the Malaysian guidelines revealed certain conceptual anomalies. These anomalies revolved around the definition given to Islamic securities, which was based on the general definition of the term "debenture" under the securities laws. Debenture, as is the case in many jurisdictions, had a rather wide definition, to include "debenture stock, bonds, notes, and any other evidence of indebtedness of a corporation for borrowed moneys, whether or not constituting a charge on the assets of the corporation." This definition was obviously incompatible with the essence of Islamic securities which are not, from any perspective, "evidence of indebtedness of a corporation for borrowed moneys."

This becomes an even bigger conceptual problem when the Islamic securities are asset-backed securities as opposed to debt-backed securities, where the debt originates from Shari'ah-compliant contracts such as murabahah and bai bithaman ajil. Debt-backed Islamic securities are very common in the Malaysian capital market, while asset-backed Islamic securities are more prevalent in other jurisdictions.

The definition above is premised on the concept of lending money on interest, which not only does not lend itself to *sukuk* structures but, more importantly, is wholly inconsistent with *Shari'ah* principles. This is to be expected when Islamic securities are issued within the general framework of existing legislation and regulations that were not drafted with Islamic finance in mind. However, it is also important to note that such problems can be addressed with relative ease once the issues are identified and the authorities take proactive measures to introduce requisite amendments.

Conventional debt securities are inherently non-Shar'iah-compliant as they involve elements of riba. In simple terms, a conventional bond reflects the acknowledgment by the borrower that he has received the stated amount of money, his agreement to pay the bondholder interest on the amount borrowed at the specified rate, and also his agreement to repay the principal on the stated maturity. It has also been described as "a certificate by which its issuer undertakes the liability of paying its face value to the bearer on its maturity along with an agreed interest relating to its value or to a pre-determined profit, either in lump-sum or as a discount or in the form of prizes to be distributed on the basis of ballot." Islamic securities, on the other hand, are typically asset-backed to eliminate elements of riba.

The success of a sukuk transaction is usually measured by the pricing and distribution achieved. Sukuk that are priced at levels substantially higher than conventional equivalents of similar credit quality would not be attractive to the issuer. Sukuk that do not appeal to a large section of investors due to non-compliance with market norms or general procedures would also not be in the best interest of the issuer. The issuer's perspective on the instrument is also relevant. While many issuers who issue Islamic securities are driven by the desire to be Shari'ah-compliant, many others are driven by commercial reasons, such as the ability to tap into an investor pool that would not be available to them in a conventional structure. As long as the issuer's business activities are not contrary to Shari'ah, any issuer should be able to issue sukuk to raise funds and the authors are not aware of any ruling that states otherwise.

The growth of the Islamic capital market is dependent on a diverse range of issuers and it is the authors' view that the regulatory environment should be as accommodating as possible. Though conventional securities and sukuk are fundamentally different instruments, they are also similar in many aspects. For example, sukuk can be structured as fixed-income instruments with fixed or floating rate coupons. They

tend to be rated on the credit quality of the ultimate obligor and listed and traded on established exchanges. They are also cleared and settled on existing international platforms such as Euroclear or Clearstream or their equivalents in domestic markets.

Islamic securities are typically sold to both Islamic investors and conventional investors. Islamic investors, as the name suggests, are investors who subscribe to Shari'ah principles and will only invest in Shari'ah-compliant assets, while conventional investors look purely at the credit quality of and returns on the securities. Rules and regulations that are put in place to govern the Islamic capital markets, if they are substantially and substantively different to what conventional investors are used to, may have the effect of marginalizing Islamic investors. Said rules and regulations should therefore be in line with general best practice standards.

Many of the most successful international sukuk transactions to date have been in compliance with Regulation S of the Securities Act 1933 of the United States. Regulation S sets out guidelines for the offering of securities outside the United States without registration under said Act; it is a "safe harbor" provision that protects investors and issuers from liability under the securities laws of the United States. Though Regulation S does not specifically refer to sukuk structures, it does not exclude them either. A Regulation S issuance is a minimum requirement for many investors, and sukuk transactions that have complied with Regulation S have attracted a high level of interest from investors and have been successfully distributed, particularly to conventional investors.

Thus far, these observations have focused on debt instruments. Equity instruments also form a substantial part of Islamic capital markets. Shari'ah-compliant shares or equities are identical in form to non-compliant shares or equities. The distinguishing factor, however, is the screening criteria that are used to determine whether a company is compliant or otherwise. The most widely accepted screening criteria are those adopted by the Dow Jones Islamic Market Indexes.

In order for a company to be classified as *Shari'ah*-compliant, it must not be involved or have material ownership in any prohibited business activities. These include alcohol, tobacco, pork-related products, conventional financial services (that is, *riba*-based financing), and the entertainment business. If the company is not disqualified based on the nature of its business, it must then pass certain prescribed financial ratios. All the following must be less than 33%:

- total debt divided by trailing 12-month average market capitalization
- the sum of the company's cash and interest-bearing securities divided by the trailing 12-month average market capitalization
- accounts receivable divided by the trailing 12-month average market capitalization.

Another set of widely used screening criteria are those used by the FTSE Global Islamic Index Series ("the FTSE Islamic Index"). The FTSE Islamic Index "is designed to identify and track a global Islamic compatible universe of publicly traded equities in a manner analogous to indices which identify and track the relevant universe of publicly traded equities, that have no restrictions imposed by Islamic Shariah precepts in the selection process. In essence, it is an Islamic stock market indicator." In order for a company to be classified as a Shari'ah-compliant company under the FTSE Islamic Index, it must not be involved in any incompatible businesses, which include ribabased banking, alcohol, tobacco, gaming, arms manufacturing, life insurance, and pork-related businesses. In addition to the foregoing, the company's gross interest-bearing debt to total assets should not exceed 33%.

It is interesting to note that, apart from the screening criteria, all other aspects of a *Shari'ah*-compliant company are similar to a non-compliant company. In fact, the screening criteria operate in isolation of the general framework of the stock market and its related rules and regulations. The concept of shares is in essence not repugnant to the principles of *Shari'ah* and there is therefore no need to establish an independent set of rules and regulations to regulate compliant shares.

### 2. HOW MUCH TO REGULATE

As mentioned above, the current approach to the equity capital market appears to be, in the authors' view, the desired approach. It is commercially friendly but does not compromise Shari'ah principles. Shari'ah-compliant shares need not be extracted from the current platform and placed on a different, specially established platform. Rules and regulations that govern the equity markets are often complex and intertwined with other more general rules and regulations, the ultimate objectives of which are to protect market players and prevent manipulation that would benefit a certain section of the market at the expense of others. These general objectives are certainly not contrary to the Shari'ah.

The argument advanced is that there is no necessity to establish a separate regulatory framework if the existing one is sufficient. Permissibility (ibahah) is an established principle under the Shari'ah, which states that "commercial transactions and contracts... are permissible unless there is clear injunction to the contrary." Existing rules and regulations that govern the capital markets in most jurisdictions are generally "Shari'ah neutral." In other words, they were not drafted with Shari'ah principles in mind, but do not contravene them either.

For the reasons described above, there is a compelling argument for sukuk and other Islamic instruments to be regulated under existing established regulatory frameworks instead of establishing a standalone framework. As discussed above, the "Guidelines on the Offering of Private Debt Securities" issued by the Securities Commission of Malaysia are a good example of how a single set of regulations can effectively regulate both types of instruments. While the guidelines were effective, there were issues, as discussed above, on whether they correctly described the nature of Islamic securities. The Commission addressed this issue by introducing the "Guidelines on the Offering of Islamic Securities" in July 2004. These guidelines are intended to apply exclusively to Islamic securities, although they adopt most of the provisions found in the earlier common guidelines.

It is to be noted that the introduction of the new guidelines does not imply that a separate framework has been established for the issuance of Islamic securities. The new guidelines originate from the existing securities regulations (and from which the previous combined regulations also originated) and do not result in any substantive change in the issuance process. All provisions relating to proposals, documents, and information that have to be submitted to the authorities and rating requirements, among others, remain unchanged. The new guidelines also set out provisions on the appointment of Shari'ah advisors, additional disclosure requirements relating to certain types of Islamic securities, and the approved concepts and principles for issuing Islamic securities.

The discussion above has revolved around integrating Islamic securities within existing regulatory platforms and, to a large extent, avoiding over-regulating them. The cornerstone of Islamic securities is the Shari'ah, and compliance with Shari'ah is paramount. The argument for a common set of regulations does not imply that Shari'ah principles will be marginalized. It is the authors' view that the Shari'ah

review and approval process must be properly regulated to ensure that said process becomes an integral part of a *sukuk* issuance.

In this regard, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has introduced a governance standard on *Shari'ah* supervision. The standard, in paragraph 2, describes a *Shari'ah* board as:

... an independent body of specialised jurists in figh almua'malat (Islamic commercial jurisprudence). However, the Shari'a supervisory board may include a member other than those specialised in figh almua'malat, but who should be an expert in the field of Islamic financial institutions and with knowledge of figh almua'malat. The Shari'a supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic Shari'a Rules and Principles. The fatawa, and rulings of the Shari'a supervisory board shall be binding on the Islamic financial institution.

The fact that the AAOIFI has a separate governance standard for *Shari'ah* supervision at Islamic financial institutions underscores the obvious importance of *Shari'ah* in the sphere of Islamic finance. The AAOIFI also has a standard that focuses on the *Shari'ah* review process,<sup>6</sup> which describes it as:

... an examination of the extent of an [institution's] compliance, in all its activities, with the Shari'a. This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc.

The [Shari'ah supervisory board] shall have complete and unbindered access to all records, transactions, and information from all sources including professional advisers and the [employees of the institution].<sup>7</sup>

The Islamic Financial Services Board (IFSB) recently released an exposure draft, which, among other things, deals with Shari'ah compliance. The guiding principle, in this regard, is that Islamic financial institutions should "have in place an appropriate mechanism for obtaining Shariah rulings, application of fatawa and monitoring

of Shariah compliance in all aspects of their products, operations and activities." The exposure draft recognizes that there will always be diversity in the interpretation of the Shari'ah and opinions therefore will vary among scholars. This diversity reflects the inherent beauty of the Shari'ah, which has universal relevance both from a geographic perspective and from a historical perspective. It is this diversity coupled with flexibility in the application of the Shari'ah that has led to the exponential growth of Islamic finance. It must be stated, however, that said diversity and flexibility are subject to stringent rules and require a thorough understanding of the Shari'ah.

Regulating the process of Shari'ah interpretation is not, for the reasons mentioned above, desirable. However, the Shari'ah review process should be regulated to ensure that certain minimum standards are adhered to. In the current Islamic finance landscape, both Islamic as well as non-Islamic institutions offer services related to Islamic finance. Most Islamic institutions presumably have rules and regulations in relation to Shari'ah review in place in line with AAOIFI standards and the proposals by the IFSB.

Non-Islamic institutions, however, are not regulated by and do not necessarily subscribe to these standards. However, such institutions have been fairly successful in offering Islamic financial products and services, including those related to Islamic capital markets. Certain jurisdictions such as Malaysia have in place regulations to ensure that any entity that is involved in the issuance of Islamic securities complies with prescribed minimum standards on Shari'ah compliance. Many other jurisdictions, however, do not, and the compliance standards adopted by institutions in such jurisdictions are determined unilaterally.

Be that as it may, several international financial institutions that are active in the Islamic capital markets do voluntarily adopt best practice standards on *Shari'ah* compliance. However, these are on an ad-hoc basis and vary substantially from institution to institution. These institutions are also dictated by the market, in the sense that they would do what is necessary or sufficient to sell their products.

Although this approach has served the market well thus far, it is not the ideal state of affairs. Shari'ah compliance is the core of Islamic finance and it should therefore not be left entirely to market forces. Guidelines or best practice standards should be introduced to regulate non-Islamic institutions offering Islamic capital market products and services. These guidelines should not be mandatory, as non-Islamic institutions would already be subject to regulatory authorities in

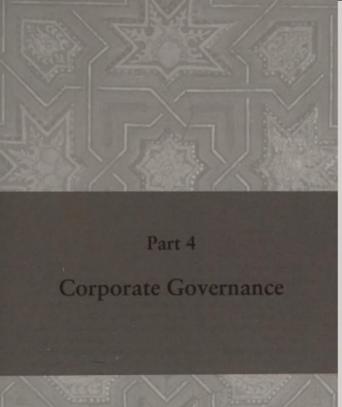
their respective jurisdictions. However, the guidelines would reflect the minimum standards and recommended best practices for such institutions, and those that adopt them will certainly enhance their credibility in the market.

Although significant challenges remain in terms of standardizing Shari'ah guidelines across different legal and regulatory jurisdictions, experience to date demonstrates the ability of Shari'ah to interact with existing legal regimes. The authors have every expectation that the pace of growth in Islamic capital markets will outstrip that of conventional capital markets. This growth will be sustained by the level of public confidence in the credibility of the efforts undertaken by the IFSB, AAOIFI, and other responsible parties to maintain standards of best practice.

#### **ENDNOTES**

- 1 "Islamic securities" and "sukuk" are used interchangeably in this chapter.
- Resolution No. (60/11/6) issued at the sixth session of the Council of the Islamic Figh Academy held in Jeddah, Kingdom of Saudi Arabia, 17–23 Sha'baan 1410 H (corresponding to March 14–20, 1990), Concerning "Bonds," Resolutions and Recommendations of the Council of the Islamic Figh Academy 1985–2000, Islamic Development Bank, 2000.
- Section 1.2, Ground Rules for the Management of the FTSE Global Islamic Index Series.
- Mohammad Hashim Kamali, Islamic Commercial Law, An Analysis of Futures and Options, Ilmiah Publishers, 2002.
- Governance Standard for Islamic Financial Institutions No. 1, Shari'ah Supervisory Board: Appointment, Composition and Report.
- 6 Governance Standard for Islamic Financial Institutions No. 2, Shari'ah Review.
- 7 Ibid., para. 3.
- S Exposure Draft No. 3, "Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)," issued on December 21, 2005.
- " Ibid., Part 3, Principle 3.1.









# Corporate Governance for Banks

Hamid Yunis

#### 1. INTRODUCTION AND BACKGROUND

In this chapter, the subject of the corporate governance of banks is considered generally, as it applies to such institutions operating in conventional markets and jurisdictions. Another chapter in this book will deal more specifically with the subject of corporate governance of financial institutions offering Islamic financial services (that is, primarily Islamic banks, but also Islamic "windows" in conventional financial institutions).

In particular, this chapter will focus on the following key considerations:

- · why corporate governance is needed
- . the different models and considerations involved
- the particular characteristics and additional factors that are relevant for banks.

The remainder of this chapter is set out in seven sections, as follows:

- 2. Why corporate governance is needed
- 3. Different models of corporate governance
- 4. Corporate governance of banks generally
- 5. Corporate governance of banks: Special characteristics
- Guidance in considering corporate governance for banking organizations

- 7. Corporate governance in Islamic banks
  - . Conclusion.

# 2. WHY CORPORATE GOVERNANCE IS NEEDED

Most countries, including members of the International Monetary Fund (IMF), have experienced problems within their banking community from time to time. The fact that these problems can still occur after the introduction – and indeed implementation – of both national and global standards and regulations gives the subject of the corporate governance of banks crucial importance.

Additionally, it should be clear to anyone involved in financial management, whether micro or macro, and interested in good market practice, that banks are extremely important for the development of a successful economy; indeed, the corporate governance of such institutions is integral to that development. Banks are in the unique position of effectively collecting and allowing the use of funds in a given manner or enterprise. Where such funds are used in a proper and consistent manner, this can lead to a stable market, lower the cost of capital, and accordingly stimulate growth in an economy as a whole.

The additional practical point of interest is that if bankers (that is, directors and senior management of banks) allocate capital efficiently, exert good and effective corporate governance in their own institutions, and also (by using their rights as providers of capital) promote good corporate governance in their customers, there will be a built-in discipline over those institutions and those customers. In contrast, if bankers enjoy too much discretion to act in their own interests rather than in the interests of their stakeholders, then banks will be correspondingly less likely to allocate funds efficiently and to promote sound corporate governance in their ultimate customers.

Accordingly, the weak or improper supervision of banks can have the disproportionate effect of destabilizing a country's economy and indeed reducing market confidence. As mentioned earlier, various banking crises over time have dramatically illustrated the catastrophic consequences flowing from the poor corporate governance of banks. These crises have crippled economies, destabilized governments, and, in a macro sense, held back the development of less sophisticated economies and emerging nations, and indeed intensified poverty.

Furthermore, when banking crises include an element of insiders exploiting a bank, or an element of fraud or negligence, this can also increase the likelihood of failure and thereby curtail economic development.

### 2.1. Systemic Risk

Good corporate governance is generally understood as an integral part of the institutional foundations of an economy and as a way to deal with and hopefully minimize systemic risk in the banking system. The chief features of systemic risk are well known and include:

- · runs (unexpected withdrawal of deposits)
- · unexpected and rapid reversals by securities holders
- · excessive volatility in the foreign currency or capital markets
- generalized symptoms of panic among depositors and asset holders.

# 3. DIFFERENT MODELS OF CORPORATE GOVERNANCE

Additionally and from a global perspective, it is worth highlighting the different aims and objectives of corporate governance. For instance, the Anglo-American model of corporate governance differs substantially from the Franco-German (Continental European) model – in particular, in their treatment of the issue of relevant "stakeholders." The former takes the view that the particular focus should be to maximize shareholder value and, accordingly, the interests of shareholders should be paramount unless management is legally or contractually required to take other interests into account.

The Franco-German (Continental European) approach, by contrast, considers "corporations" to be industrial partnerships in which the interests of long-term stakeholders, particularly debt providers or funders and employee groups, and also the host community, should not be subordinated to those of shareholders.

The first position may be called the "neo-liberal" and the second, the "societal." The "neo-liberal" position corresponds to the prevailing political and economic conditions and the development of the macroeconomies of the United States and the United Kingdom. The "societal" position is more consistent with the political consensus of a "centrist" social model, which has also been characterized as "neo-corporatist."

Additionally, the neo-liberal position takes a narrow view of stakeholders and their rights. This is illustrated by the framework for financial reporting developed by the Financial Accounting Standards Board in the U.S. (Statement of Financial Accounting Concepts No. 1), and the International Accounting Standards Board (IASB Framework), as well as by the U.K. Financial Reporting Council's (FRC) Code of Corporate Governance. The latter has been endorsed by the Financial Services Authority, the financial regulator for the U.K.

The FRC Code refers, in particular, to the following characteristics:

- use of a voluntary code of good practice to be observed by corporations to promote good corporate governance over and above the basic requirements of company law
- no specific focus on corporate social responsibility but a strong focus on the rights of shareholders
- reliance on "socially aware" shareholders to enforce socially responsible behavior by management and "market discipline" to be exercised by investors, without reference to any other stakeholder groups.

By way of contrast, and again as highlighted above, the societal position considers a set of stakeholders in addition to shareholders that includes employees and other groups affected by the organization's activities. Such groups are entitled to representation in the organization's organs of governance – namely, its supervisory board or similar organs. There is a specific focus on corporate social responsibility, and in that connection the public interest may be represented by supervisory or "supra" board members with governmental affiliations. While this model enforces consensus behavior between the leaders of industry and representatives of labor, with the government playing a mediating but also a proactive role, the societal position on corporate governance places less reliance than the neo-liberal position on market discipline and voluntary codes.

Notwithstanding the ideological and contrasting positions of the two models, this chapter does not seek to analyze the differences in any great detail nor to consider the advantages and criticisms of each. The distinctions between these two particular models are, however, quite useful in understanding some of the points made in this chapter.

# 4. CORPORATE GOVERNANCE OF CORPORATIONS GENERALLY

## 4.1. Definition of Corporate Governance

We think it is helpful to consider the definition of corporate governance. The Organisation for Economic Co-operation and Development (OECD) principles define corporate governance as being a:

... set of relationships between a [company's] management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which the objectives of [the company] are set, and the means of attaining those objectives and monitoring performances are determined. Good Corporate Governance should provide proper incentives for the Board and management to pursue objectives that are in the interests of [the company] and its shareholders and should facilitate effective monitoring. The presence of an effective Corporate Governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy.

Additionally, and perhaps of assistance for the remainder of this chapter, corporate governance can also be defined as a set of organizational arrangements whereby the actions of the management of a corporation are aligned as far as possible with the interests of its respective stakeholders, taking into account the various models discussed previously.

Corporations, in this respect, include private-sector firms and public-sector bodies having corporate form as legal entities. The rights of a stakeholder may be established by law or by an organization's statutes or by-laws, or they may arise from codes of practice or affiliation codes – that is, stock exchange regulations.

# 4.2. Rights of Stakeholders

Stakeholder rights may be of the following three kinds: control rights, cash flow rights, and information rights. Stakeholders possessing control rights, such as ordinary shareholders, can in principle use them to secure cash flow rights (for example, rights to dividends) and information rights (for example, rights to an annual report). Other

stakeholders (such as creditors) may possess or have claims to cash flow or information rights without normally possessing control rights. (Creditors may obtain control rights in case of default.)

### 4.3. Islamic Banks

In the context of an Islamic bank, good corporate governance should also encompass:

- a set of organizational arrangements whereby the actions of the management of Islamic banks are aligned, as far as possible, with the interests of its stakeholders
- the provision of proper incentives for the organs of governance such as the board of directors, the Shari'ah board and management, to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging Islamic banks to use resources more efficiently
- compliance with Islamic Shari'ah rules and principles.

This aspect is further developed in Chapter 17.

## 4.4. Different Levels of Governance

Notwithstanding the points made above, while the banking community is vitally important, banks are commercial entities just like other corporations in the wider economy and market. Accordingly, it is fair to say that corporate governance requirements of commercial entities and corporations apply generally and equally to banking organizations.

For general corporations, the level of governance includes different levels of disclosure and supervision required by:

- individual shareholders and "connected" shareholders with common interests
- debt providers
- suppliers
- · institutional equity and debt providers
- · boards of directors
- · market perceptions.

Each of these requires a degree of understanding and, in this respect, most national and international corporate legislation and general principles of corporate governance try to create appropriate checks and balances to do just that and to assist in creating safeguards. This view also takes into account that a corporation is basically a set of contractual arrangements between different groups of stakeholders that is, in most jurisdictions, given a legal status. In addition to the list above, the groups of stakeholders may be considered to include its creditors, employees, the community in which it operates, and, of course, its customers. In the case of banks, these stakeholders will also include the regulators in their role as insurers of deposits and lenders of last resort and, of course, in their capacity as agents of other stakeholders, particularly in a distressed situation.

Consideration should also be given to the nature in which fiduciary duties are owed to these different stakeholders.

## Shareholders (small, large, and "connected")

Shareholders can be divided into various categories from a corporate governance perspective, and in particular there is a distinction between those who possess a small shareholding and therefore are unable by themselves to exert any substantial control, those who have a shareholding that is large enough to allow them to appoint at least one member of the board of directors, and those who (while not by themselves large shareholders) are "connected," in some manner, with other shareholders and therefore, through the connection, are able to exercise a much stronger influence.

In each case, shareholders exert corporate governance directly through their voting rights and indirectly through the board of directors as permitted pursuant to a corporation's constitution.

Notwithstanding that position, the difference between small shareholders on the one hand and large and "connected" shareholders on the other hand, is that the former have a limited flow of information, and can rarely exercise their individual rights to ask for more than that permitted pursuant to specific legislation or within the corporation's constitution. Small shareholders also have very little by way of ongoing monitoring functions. Additionally, their ability to influence the composition of a board of directors or indeed to have someone actually representing their interests is extremely limited.

While, in many countries, it is fair to say that legislation exists to protect minority shareholders, this is by no means comprehensive and the economic disadvantages of actually taking any action (whether this is through legal proceedings or otherwise) can work against this being an effective tool.

On the other hand, groups of "connected" shareholders can exercise their influence with a view to influencing representation on the board of directors and thereby create control mechanisms. "Connected" shareholders will also be more effective at exercising their voting rights through an ownership structure.

However, notwithstanding the general points referred to above, large or "connected" shareholders exercising their influence can also have real disadvantages for the proper corporate governance of a corporation. For instance, they can impede the proper governance of a company through mechanisms that may have been created to cater specifically for their needs. Large or "connected" shareholders can have mechanisms (for example, board members) in place to keep checks on the management and ensure that their interests are not merely protected but even advanced to the detriment of other stakeholders, particularly minority shareholders.

## Debt providers (including banks)

In relation to debt providers, this category could include suppliers and customers who operate on a credit basis and would also include institutional equity and debt providers – in particular, banks.

Most banking documentation, in respect of loan and security arrangements, will include extensive covenants, representations, and warranties together with information disclosure requirements. If the corporation violates those covenants or defaults on the payments, then the banks concerned can usually obtain the rights to repossess collateral. Clearly, the effective exertion of the control rights of a debt provider depends on the efficiency of the legal and bankruptcy systems and, indeed, on how effectively any written instrument may be prepared.

Again, there is a difference between large debt holders and those who have a greater share of the debt and indeed have secured positions. Legal systems in many countries give companies the right of an automatic stay on assets for a period of time during which the management may be able to remain in place pending a decision by the insolvency courts. This restriction of creditors' control rights in case of default makes repossession of assets difficult even for secured creditors and reduces the governance power of debt holders.

Nonetheless, in general such rights provide a good governance mechanism to monitor management. This allows banks to monitor that the corporation is operating at an appropriate level and in an appropriate management and administrative context. Because of their usually large investments, banks are more likely to have the ability and the incentives to exert control over a corporation by monitoring and influencing the composition of the board.

The other curious situation is that while banks themselves can play a significant role in the governance of nearly all sorts of firms and corporations, despite the general focus on the corporate governance of banks, little attention has actually been paid to corporate governance by banks (except when they have board representation).

#### Market considerations

Finally, the market itself plays a role in making sure that appropriate mechanisms are in place for the good corporate governance of corporations and for them to remain competitive. In particular, the growth of rating agencies and data intelligence allows corporations to be compared and also for those doing business with those corporations to gauge performance and, indeed, monitor or look for early signs of failure. It can be argued that, through the "market for corporate control," the board of directors and senior management of a poorly managed corporation may be targets for displacement through the acquisition of the corporation (with the backing of discontented shareholders) by a more effectively managed corporation.

### CORPORATE GOVERNANCE OF BANKS: SPECIAL CHARACTERISTICS

As underlined above, it should be remembered that the general principles of corporate governance that apply to corporations as a whole also apply to banks. Notwithstanding that general position, it is fair to say that banks have an additional layer of specific characteristics that require an additional layer of analysis.

## 5.1. Bank-specific Features

The following features of banks are distinctive:

 Banks operate in a different manner to general corporations in the delivery of their business and their position in the market. Accordingly, it is important to create, either willingly or through regulation, a degree of transparency to allow for customer and market confidence. On the other hand, groups of "connected" shareholders can exercise their influence with a view to influencing representation on the board of directors and thereby create control mechanisms. "Connected" shareholders will also be more effective at exercising their voting rights through an ownership structure.

However, notwithstanding the general points referred to above, large or "connected" shareholders exercising their influence can also have real disadvantages for the proper corporate governance of a corporation. For instance, they can impede the proper governance of a company through mechanisms that may have been created to cater specifically for their needs. Large or "connected" shareholders can have mechanisms (for example, board members) in place to keep checks on the management and ensure that their interests are not merely protected but even advanced to the detriment of other stakeholders, particularly minority shareholders.

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- Banks are generally, even in emerging economies, heavily regulated when compared to other corporations (as opposed to industry regulation – such as for oil and gas).
- 3. Banks have:
  - · a wider definition of "stakeholders"
  - · mechanisms to avoid the issue of "systemic risk"
  - additional regulation and compliance issues
  - the interests of depositors requiring protection
  - · the need for strong internal control and risk management
  - particular issues of related party transactions (and "grey directors").

Corporate governance from a banking industry perspective also deals with, among other factors, the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management which affects how banks:

- set corporate objectives
- · run on a day-to-day basis
- meet the obligations of accountability both internally and externally
- · align corporate activities and behavior
- · protect the interests of depositors and other customers.

It was mentioned earlier that the scope of the duties and obligations of corporate officers and directors should be expanded in the case of banks. One argument put forward is that the special corporate governance status concerning banks weakens the case for making shareholders (small, large, or indeed "connected") the only beneficiaries of the fiduciary duties that were discussed above.

It is not intended to go into great detail here about the interpretation of this duty of care; however, this principle is reiterated for further consideration. It is that bank directors should be held to a higher standard of care than other corporate directors.

### 5.2. Regulation

Governments have also sought to impose general rules and regulations on banks. Most governments also restrict the concentration of bank ownership and, indeed, the ability of outsiders to purchase a significant stake in a bank, without governmental approval. However, it should also be noted that there are many cases where governments themselves own or have control of banks.

It can be argued that banks are not the only regulated industry and that governments regulate other types of firms as well. However, even in countries where the governments intervene very rarely in the private sector, they tend to impose extensive regulation on the banking industry. This is apparent not only in developing economies but also in the more sophisticated economies of North America, Western Europe, and Japan. Additionally, standards published by various supranational bodies such as the World Bank and the IMF virtually insist on some form of public or government surveillance of the banking industry.

A key consideration for the corporate governance of banks, therefore, is that banks operate in a regulated environment. In general, regulation emphasizes the need to maintain confidence and integrity in the financial market systems. Excessive risk taking by a bank has important implications for the market as a whole. This creates the potential for the systematic risks that were mentioned in the introduction to this chapter.

Effective rules and regulation have at least four benefits. These include:

- the existence of an external set of criteria, independent of the market, which affects both the owner and the manager
- · an external governance influence on the bank
- the existence of both the regulator and regulations implies that market forces will create practical and necessary disciplines on both the managers and the shareholders in a different way compared to unregulated firms
- in order to prevent systemic risk, regulation means that a second and external party should be monitoring banks' risks and the quality of their risk management.

Regulation is also important to represent the public interest or the public good. Accordingly, it is worth considering what works best. In this respect, it has been argued that over-zealous regulation has a negative effect on a bank's development and equally on the bank's relationships with its customers. A sensitive degree of regulation, on the other hand, aligned with the general interests of the market and the economy as a whole, balances the needs for proper supervision with the market and political needs.

## 6. GUIDANCE IN CONSIDERING CORPORATE GOVERNANCE FOR BANKING ORGANIZATIONS

Guidance is implemented and/or readily available for those considering how corporate governance for banks can be enhanced. In particular, the Basel Committee on Banking Supervision (BCBS) published guidance in 1999 entitled "Enhancing Corporate Governance for Banking Organisations." This guidance was published to assist banking supervisors in promoting the adoption of sound corporate governance practice by banks in their particular countries. The guidance also drew from principles of corporate governance for corporations generally that were published by the OECD with the purpose of assisting governments in their efforts to evaluate and improve their frameworks for corporate governance and to provide guidance for financial market regulators and participants in the financial market.

Since the publication of the original OECD corporate governance guidance and the BCBS document in 1999, it has become increasingly clear, notwithstanding the continuing (though reducing) incidence of bank failures, that as the financial markets develop there is a need for updated guidance.

The OECD published revised corporate governance principles for corporations in 2004. Following on from the publication of those revised principles, in 2006 the BCBS issued a revised version of its paper "Enhancing Corporate Governance for Banking Organisations." These principles have developed together with a dialogue, both internationally and nationally, on corporate governance standards generally. Additionally, bodies such as the Islamic Financial Services Board have published corporate governance guidance in relation to institutions offering Islamic financial services.

The latest version of the BCBS paper sets out a broad framework for fundamental corporate governance principles to guide the actions of directors, managers, and supervisors of a diverse range of banking organizations. The paper argues that sound governance can be achieved regardless of the corporate form used in a banking organization and is distinct from national differences.

Four important forms of oversight should be included in the organizational structure of any bank in order to ensure appropriate checks and balances. These include the following:

- · oversight by the board of directors or supervisory board
- oversight by individuals not involved in the day-to-day running of the various business areas
- · direct line supervision of different business areas
- independent risk management, compliance, and audit functions.

An additional principle that is now engrained in the corporate governance of firms and corporations generally, and in particular for those involved in the financial services sector, is that the key personnel are "fit and proper" for their roles.

The general principles of sound corporate governance also need to be applied to state-owned or family-owned enterprises. The 2006 paper highlights the following principles:

- establishing strategic objectives in a set of corporate values that are communicated throughout the banking organization
- setting and enforcing clear lines of responsibility and accountability throughout the organization
- ensuring that board members are qualified for their positions (the "fit and proper" text referred to above), have a clear understanding of their role in corporate governance, and are able to exercise sound independent judgment about the affairs of the bank
- ensuring that there is appropriate oversight by senior management
- effectively utilizing the work conducted by internal and external auditors as well as other controlled functions in recognition of their critical contribution to sound corporate governance
- ensuring that compensation policies and practices are consistent with the bank's ethical values, objectives, strategy, and control environment
- · conducting corporate governance in a transparent manner
- maintaining an understanding of the bank's operational structure, including (and especially) when operating in jurisdictions or through structures that impede transparency – that is, "know your structure"
- ensuring an environment supportive of sound corporate governance.

Some specific corporate governance considerations applicable to banks are also mentioned in Pillars 2 and 3 of the New Capital Accord published by the BCBS in June 2004. These include the need for banking supervisors to pay particular attention to risk management, transparency, and market discipline.

## 7. CORPORATE GOVERNANCE IN ISLAMIC BANKS

As we have mentioned earlier in this section, corporate governance in banking has been analyzed almost exclusively in the context of conventional banking markets. By contrast, until very recently, little has been written on appropriate governance structures or guidelines in Islamic banking, despite the rapid growth of Islamic banks that started in the last decade of the 20th century.

The question arises as to the extent to which Islamic banking, being based on a set of principles that differentiate it from conventional banking, needs to be differentiated from the viewpoint of corporate governance. My view is that the corporate governance of conventional banks is not inconsistent with what is required for Islamic banks. However, it is fair to say that there are a number of additional features that need to be taken into account because of the different relationships and requirements of Islamic banks.

### 8. CONCLUSION

Corporate governance of banks is of fundamental importance for those who are concerned with or have the responsibility for financial regulation and for developing markets and economies. Its proper implementation will minimize the incidence of systemic risks and the likelihood of banking crises of the nature referred to at the beginning of this chapter.

Corporate governance of banks needs to adopt the standards used to regulate corporations and firms in general, but we should also recognize the special characteristics of banks themselves and the special position that they occupy in the economy. In terms of the corporate governance models discussed earlier in this chapter, one may conclude that the societal model with its acknowledgment of a number of stakeholder groups may seem more immediately applicable, while the governance rights normally possessed by shareholders give them a potentially key role (emphasized in the neo-liberal model) which must not be overlooked. I would suggest that such a conclusion is right; the wider definition of stakeholder for banks is what is required

and allows a proper consideration of what checks, balances, and protections may be required.

In considering this subject in any great detail, be it from an academic or practical point of view, substantial and valuable guidance is available, important aspects of which I have referred to above. This will develop as markets, products, and financial systems develop and increase in size, and as innovation continues.

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# Specific Corporate Governance Issues in Islamic Banks

Simon Archer and Rifaat Ahmed Abdel Karim

### 1. INTRODUCTION

D ecently, there has been a growing interest in the corporate governance of banks (Macey and O'Hara, 2003; Caprio and Levine, 2002; Levine, 2003; Charkham, 2003). However, according to Levine (2003), the need for a separate analysis of the corporate governance of banks is not self-evident and requires justification. This is because, like any other organization, banks have shareholders, debt holders, boards of directors, competitors, and so on Caprio and Levine (2002) and Levine (2003) identify three characteristics that they claim warrant an independent discussion of the governance of banks. They argue that banks are generally more opaque than other financial institutions, which fundamentally intensifies the agency problem. Second, banks are exposed to heavy regulation. Third, the widespread government ownership of banks raises specific governance issues, Charkham (2003:15) adds: "Banks are different from the generality of companies in that their collapse affects a far wider circle of people and moreover may undermine the financial system itself, with dire effects for the whole economy."

The debate in the corporate governance literature has mainly concentrated on whether corporate governance should focus exclusively on protecting the interests of shareholders, or whether such a focus should be broadened to protect the interests of other stakeholders (Macy and O'Hara, 2003). A central issue in this debate is

whether the directors of the organization owe fiduciary duties of care and loyalty only to the shareholders of the organization, or also to other stakeholders. What may be termed the "Anglo-American" or "neo-liberal" approach to corporate governance adopts the view that creation of value for shareholders should be given priority over the interests of other stakeholders. On the other hand, the "Continental European" approach (whether neo-statist as in France, or neo-corporatist as in Germany) to corporate governance calls for equal attention to be given to the interests of the other stakeholders in the organization as well as to those of the shareholders.

Islamic banks are ethically funded organizations that cater for the growing needs of Muslims who adhere to the Shari'ah law in investing their funds. These banks are currently the main type of financial institutions available for Muslims, because non-bank forms of intermediation in Islamic finance, unlike their conventional counterparts, are neither traditionally relied on nor well-developed. A recent report by the International Organization for Securities Commissions (IOSCO) confirms the dominance of the Islamic banking sector within the Islamic financial services industry. It states, "As a result of its early head-start, Islamic banking is today the most developed component in the Islamic financial system and Islamic banks represent the bulk of Islamic financial institutions worldwide" (IOSCO, 2004:14–15).

In place of interest-bearing deposits, Islamic banks mobilize funds through profit-sharing and loss-bearing investment accounts whose returns are, as a matter of Shari'ah jurisprudence (that is, that of the mudarabab contract, as explained below), based on the performance of the asset portfolios in which their funds are invested. In the majority of Islamic banks, such investment accounts contribute the preponderant amount of the funds available to the bank for investment. However, investment account holders (IAHs) lack rights of governance such as shareholders enjoy, although like shareholders they are (legally speaking) a type of equity holder with residual claims to their share of the bank's assets (Archer et al., 1998). While debt holders, with fixed contractual claims to the firm's cash flows and assets, do not need a governance structure provided that these claims are met, residual claimants by definition have no such contractual rights and thus require a governance structure to protect their interests (Williamson, 1996:Chapter 12). As Williamson (loc. cit.) points out, the law typically provides a governance structure for debt holders in case of default. In the case of IAHs, neither the Shari'ah nor secular law makes any such provision.

The absence of any governance structure in the case of IAHs is thus an anomaly, and raises fundamental corporate governance issues – for example, possible conflicts of interest between the two classes of equity holders, disclosure of adequate information to enable IAHs to protect their interests, and so on. It also draws attention to market discipline, which is emphasized for the first time by the Basel Committee on Banking Supervision (BCBS) in its new capital adequacy framework (2004), and raises the issue of the extent to which IAHs have the necessary mechanisms to exercise effective discipline on the management of the bank, given their lack of governance rights. Furthermore, the mobilization of funds through IAHs highlights the need to examine the approach adopted by central banks to regulate Islamic banks in order to help sustain the soundness and stability of the financial systems in the countries in which these banks operate.

This chapter attempts to enhance our understanding of the intricacies of corporate governance, market discipline, and regulation of Islamic banks. It argues that the existence of such profit-sharing and loss-bearing investment accounts with their equity-like, rather than liability-like, characteristics according to Shari'ah jurisprudence, together with a lack of clarity regarding the status of these investment accounts in practice, raise important questions of corporate governance, transparency, market discipline, and regulation for Islamic banks which are examined below.

The remainder of the chapter is organized as follows. Section 2 discusses the salient characteristics of Islamic banks. Section 3 considers corporate governance issues of Islamic banks, and Section 4 examines the exercise of effective market discipline on the management of Islamic banks. The regulation of Islamic banks is addressed in the penultimate Section 5, and some concluding remarks are made in Section 6.

### 2. SALIENT CHARACTERISTICS OF ISLAMIC BANKS

Islamic banks (like any type of Islamic business organization) are established so as to conduct their financial transactions in accordance with Islamic *Shari'ah*<sup>1</sup> rules and principles, which prohibit, among other things, the receipt and payment of *riba*<sup>2</sup> (interest). This means that Islamic banks cannot enter into interest-bearing borrowing or lending contracts.

As an alternative to the payment of interest, Islamic banks use two main types of accounts to mobilize funds, namely: (a) investment accounts, which are in most cases based on a version of the profitsharing and loss-bearing mudarabah contract3 under which the funds are managed on behalf of their holders; and (b) current accounts, Investment accounts, unlike equity shares, are of limited duration and holders have the right to withdraw their funds subject to certain conditions (see below). Current accounts are sight deposits - that is, debt claims on the bank which can be withdrawn at any time - and are not entitled to any remuneration; they are "capital certain" since repayment is a contractual right protected by the bank having adequate equity capital. Islamic banks, therefore, perform a combination of two basic functions to mobilize funds, investment management and commercial banking, in addition to raising funds by issuing equity shares. As an alternative to lending funds and charging interest on them, Islamic banks use various Shari'ah-compliant contracts (for example, murabahah, musharakah, ijarah, salam, istisna'a, and so on)4 to invest funds available, which include funds under management for IAHs as well as the bank's own (shareholders') funds and those from current accounts. (See Exhibit 17.1 for a stylized balance sheet of an Islamic bank,) Funds under management for IAHs include both unrestricted and restricted IAH funds. The funds of the unrestricted IAHs are invested at the bank's discretion, normally in the same asset pool as that in which the bank's own funds and those from current accounts are placed. In contrast, the funds of the restricted IAH are invested in asset pools that are separately designated and distinct from the bank's own funds (see Exhibit 17.1).

EXHIBIT 17.1 Stylized balance sheet of an Islamic bank

ASSETS	LIABILITIES
Cash and cash equivalents	Current accounts
Sales receivables	Other liabilities
Investment in securities	
Investment in leased assets	
Investment in real estate	Equity of Investment Accounts
Equity investment in joint ventures	Investment accounts
Equity investment in capital ventures	Profit equalization reserve
Inventories	Investment risk reserve
Other assets	Owners' Equity
Fixed assets	

Islamic banks do not erect "firewalls" to separate, legally, financially, and managerially, their investment management and commercial banking services. Instead, as noted above and in contrast to the regulatory requirements in a number of European countries, the majority of Islamic banks commingle unrestricted IAH funds with their own funds, invest both under the bank's management in the same investment portfolio, and report these investments and their results in the bank's balance sheet and income statement. Hence, unrestricted IAH funds are far from being "ring fenced" from the bank's own funds.

The relationship between IAHs as providers of funds and the bank in its capacity as fund manager is in most cases regulated by the mudarabah form of contract, which has detailed juristic rules derived from the Shari'ah.<sup>6</sup> One of the absolute requirements for a valid mudarabah is the transfer of control over investment decisions, including all operating policies of the mudarabah, from the IAHs to the bank as mudarib. IAHs have no right to intervene in these investments and policies, which are the sole prerogative of the mudarib. A clear separation must occur between IAHs and their invested capital. However, unlike the situation with shareholders, this separation of capital ownership from management under mudarabah as currently applied does not provide any rights of governance or oversight to IAHs in exchange for their funds, as will be elaborated below. This sets the agency perspective of corporate governance of IAHs, which is unique to Islamic banks.

According to Udovitch (1970:190):

This [arrangement] ... in no way implies a transfer of ownership of the investment capital from the investor to the agent [mudarib]. While the agent's control over the disposition of the investment is almost absolute, its ownership unequivocally remains with the investor [IAH].

This personal form of ownership of the capital and of the assets in which it is invested contrasts with the impersonal form of the entity which is based on "the legal 'separation' of share ownership from ownership of the business assets" whereby "a company is legally the owner of its business assets, and the shareholding members have only the rights that are attached to their ownership of share capital" (Scott, 1997:3). The mudarabah concept of the personal form of ownership has implications for the accounting definition of an asset when Islamic

banks report, as is currently the practice, on their balance sheets the assets financed by unrestricted IAHs.<sup>7</sup> Furthermore, it is not clear how the underlying assets of Islamic *sukuk* (bonds), which use the *mudarabah* contract to mobilize funds, will be characterized in terms of this concept of ownership – that is, what kind of ownership claim over the underlying assets is conferred by the *sukuk*.

One of the reasons for the separation of ownership from management in the *mudarabah* is that it is classified as a *fiduciary* contract, and the *mudarib* 

... is considered a trustworthy and faithful party (amin) with respect to the capital entrusted to him, and therefore not liable for any loss occurring in the normal course of business activities; [however, the mudarib]... becomes liable for the property in his care as a result of any violation of this fidelity. (Udovitch 1970:203–04)

To fulfill its fiduciary duty, the bank (as mudarib) is expected to generate the maximum profit for and to act in the best interests of IAHs (Saleh, 1992). Indeed, the primary duty of the mudarib is to comply with the trust vested in it when managing the funds of IAHs. This means that the management of the Islamic bank owes a fiduciary duty to two categories of equity holders, shareholders and IAHs, whose interests may not necessarily be congruent.

As a profit-sharing and loss-bearing financial instrument of limited duration, the *mudarabah* contract is neither a financial liability nor an equity instrument in the normal sense. According to Udovitch, it "combine[s] the advantages of a loan with those of a partnership; and while containing elements characteristic of both it cannot be strictly classified in either category" (1970:171). In fact, *mudarabah* is sometimes described as a "partnership between work and capital," where the provider of capital is the owner of the "partnership" assets. It should therefore be noted that an investment made under a *mudarabah* contract, as an *equity* investment, raises governance issues that do not apply to a loan.

However, unlike conventional equity instruments such as common shares, whose owners can have access to their capital only by selling them, IAHs are entitled to be repaid their capital which is redeemable at maturity or at the initiative of their holders, but at net asset value, which in the event of losses will be less than the amount invested. This is because the mudarabah is a non-binding contract and "as such either of the contracting parties involved therein may disengage

himself at the moment of his choice either because he has lost his confidence in the other contracting party or because the latter has violated the trust, or even for no reason at all" (Saleh 1992:139). However, the current practice in most Islamic banks is that IAHs (usually) have to secure the prior consent of the bank before they can withdraw their funds before maturity. Islamic banks can refuse to pay IAHs until the results of the investments financed by IAHs' funds are determined,9 so that any losses can be taken into account. However, such a practice can expose the bank to reputational risk and impair its ability to attract potential IAHs. A number of Islamic banks maintain reserves against losses on IAH investments, a practice which mitigates the risk of paying out an amount in excess of its strict entitlement to an IAH who withdraws.

As noted above, IAHs lack the governance rights that company law accords to shareholders. They do not have: (1) the benefit of a board of directors to monitor management on their behalf, whose members they appoint and can dismiss; (2) the right to receive an annual report and to appoint external auditors to audit it; (3) the right to take part and vote in an annual general meeting or other general assembly; and (4) the right to participate in appointing the Shari'ah supervisory board10 of the bank. Contractually, IAHs may not "interfere in the management of their funds," and violation of this condition can nullify the contract. This requirement not to "interfere in the management" is (questionably) interpreted as implying that IAHs have no right whatsoever to governance or oversight over the management of their investment. This means that the only possible means by which IAHs can express their dissatisfaction with the bank's performance is to exercise their right to terminate their contractual relationship with the bank and "vote with their feet" by withdrawing their funds.

As already noted, according to Shari'ah jurisprudence Islamic banks do not guarantee the value of these investment accounts; 11 nor do IAHs have the powers of creditors, who have a variety of control rights which they obtain when firms default or violate debt covenants, and which include the right in those circumstances to interfere in the major decisions of the firm. 12 Their residual claim on the earnings or assets that relate to their funds ranks similarly to the residual claim of the shareholders on the bank's earnings or assets. 13 Moreover, while the mudarabah contract is neither a debt nor a conventional equity instrument, neither is it a type of conventional hybrid instrument.

comprising debt and equity characteristics. (For example, it is not debt with an embedded equity derivative.)

In the unrestricted type of mudarabah, IAHs authorize the bank to invest their funds at its discretion, including commingling the IAHs' funds with those of shareholders. In the restricted mudarabah, in principle IAHs specify to the bank, among other conditions, <sup>14</sup> the type of investment in which their funds should be invested – for example, real estate, currencies, leasing, and so on. In practice, Islamic banks offer a variety of "off-the-shelf" mudarabah investment funds, each with a specified (restricted) type of asset allocation, from which investors may choose. Hence, although holders of both types of investment accounts are exposed to different degrees of risk, their relationship with the management of the bank is subject to the same (very weak) monitoring arrangements provided by the mudarabah contract.

The aggregate investment portfolio of an Islamic bank is usually financed by unrestricted IAH funds, plus shareholders' equity and funds from other sources (for example, current accounts), the latter being mobilized on bases other than the *mudarabah* contract. If the aggregate investment portfolio yields a positive return, then the shares of profit are allocated between the parties to the contract, IAHs, and the bank, according to their proportionate shares of their respective investments in the portfolio. The bank is also entitled to any profit earned from investing the funds provided by current accounts, as well as a contractual *mudarib* share of the profit allocated to the IAHs as its fee for managing their funds.

The bank's share of profit relates to both its shareholders' funds and to other funds invested in the investment portfolio that do not participate in profit sharing (for example, as noted above, current accounts which are capital-protected but non-participating). <sup>15</sup> It is to be noted that shareholders' funds invested in the investment portfolio (and elsewhere) and the other non-participating funds are not covered by the *mudarabah* contract, and are not governed by its rules. Hence, the bank's shareholders receive the entire profit from these sources, and IAHs cannot claim any profit share from them. The *mudarib* share of profit allocated to the bank as a fee for managing IAH funds also constitutes a most important source of income to the bank's shareholders.

If the bank's aggregate investment portfolio yields a negative return, then, according to the *mudarabah* contract, this loss should be borne by IAHs and shareholders *pro rata* to their respective

investments in this portfolio, bearing in mind what was said in the previous paragraph. Like that of shareholders, the liability of IAHs is limited to the amount of their investment and no more. In the case of a negative return, in addition to the shareholders' proportion of the loss that is determined pro rata as indicated above, the bank in its capacity as mudarib receives no profit-sharing fee on behalf of its shareholders (the mudarib share of profit having a lower bound of zero). However, according to the mudarabah contract, if the loss is due to misconduct or negligence of the mudarib, then the Islamic bank has to make good the loss. 16 This exposes the bank to fiduciary risk. In both cases of losses, the bank is likely to face reputational risk. As yet, however, in the absence of judicial findings it is far from clear what would constitute "misconduct or negligence," and in particular how serious a lack of due diligence would have to be in order to be so classified. In general, this would be a matter for the secular courts to decide based on the applicable law of contract. 17

## 3. CORPORATE GOVERNANCE ISSUES IN ISLAMIC BANKS

As already noted, the characteristics of Islamic banks imply that the management has a fiduciary duty to two categories of equity holders: shareholders and IAHs. The fiduciary duty which management owes to the shareholders in an Islamic bank does not differ from that in any other organization. The fiduciary duty that the bank, represented by its management, owes to IAHs is governed by the mudarabah contract. However, judging by the position in other organizations,

The standard law and economics view regarding fiduciary duties is that corporations and their directors owe fiduciary duties to shareholders and to shareholders alone. (Macy and O'Hara, 2003:94)

This puts the management of an Islamic bank in a difficult position and complicates the corporate governance of these banks. Vogel and Hayes also appreciate this dilemma by wondering, "How can equity be ensured between the shareholders who are investors in the bank, on the one hand, and depositors who are investors in mudaraba funds managed by the bank, on the other?" (1998:133). Indeed, it is believed that

The confusion of ... trying to ... require directors to balance the interests of various constituencies without according primacy to shareholder interests would be profoundly troubling.... If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. (ABA Committee on Corporate Laws, 1990:2253)

Although IAHs are equity holders and residual claimants, and the bank in its capacity as a mudarib owes them a fiduciary duty which should rank pari passu to that of the shareholders, IAHs seem to be the party whose rights might be compromised. This appears to be due not to the governance characteristics of the mudarabah contract as such, but rather to the context in which it is currently used in Islamic banking. If the mudarabah contract were used to mobilize funds in a collective investment scheme, the scheme manager would accord primacy to the interests of the holders of the mudarabah certificates because they would be the owners of the fund. However, it is the use of the mudarabah contract to mobilize funds by Islamic banks in the context of a legal entity that has its own shareholders that seems to put the management of the bank in an ethical dilemma when they are faced with a conflict of interest between the two categories of equity holders, bearing in mind that it is the shareholders who have the right to appoint, evaluate, and dismiss the management of the bank. This has the effect of relegating the status of IAHs (particularly unrestricted IAHs) to that of "second-class" equity holders, It is also an anomaly insofar as their status as residual claimants pari passu with the common shareholders should entitle them to the rights of governance which, for good reason, normally attach to that status (Williamson, 1996:Chapter 12). Thus, in the event of a conflict of interest between them and the common shareholders, they are clearly at an important disadvantage.

This raises the following fundamental question: why do unrestricted IAHs deposit their funds with Islamic banks to manage these funds on their behalf as equity investors, while they do not get any governance rights in exchange for their funds and the risk they bear, but only the hope that they will receive a return on those funds? While, as Shleifer and Vishny (1997) point out, the same question may be asked in respect of equity investors (and especially minority shareholders) in other organizations, the situation in the case of unrestricted IAHs is worse. They are denied any governance mechanism

that could serve to safeguard their interests and to mitigate potential conflicts of interest between them and the common shareholders (that is, between two categories of principals) on the one hand, and between them and the bank's management as the agent both for them and for the common shareholders on the other hand.

One possible explanation is hypothesized by Archer et al. (1998) who pose the question: how may IAHs influence the behavior of the bank's management in order to safeguard their own interest within the terms of the mudarabah contract? Archer et al. suggest that IAHs may be able to safeguard their own interest by relying on shareholders' monitoring to operate on their behalf, if it can be assumed that there is no significant conflict of interest between the two parties. Archer et al. call this "vicarious monitoring." In many cases, both shareholders and IAHs face the same portfolio investment risk insofar as the funds of both parties are commingled and invested in the same investment portfolio, this being so in many Islamic banks. Accordingly, it would seem that the IAH could expect a gross rate of return not less than the minimum that shareholders would expect to earn from investing their funds in a portfolio of projects of the same degree of risk, 18 (Both IAHs and shareholders must meet certain expenses out of their gross returns; in the case of IAHs, the major expense is the mudarib share of profit to be paid to the bank.) On the other hand, if the aggregate investment portfolio yields a negative return, both parties lose part of their equity. In addition, shareholders lose their (i.e. the bank's) mudarib share of profit, although this can never be negative. (Assuming risk-neutrality of both parties, this asymmetry with respect to the mudarib share would not result in any conflict of interest. However, this may be a strong assumption. In particular, IAHs may be more risk-averse than shareholders.)

Moreover, even if the two sources of funds are neither commingled nor invested in the same investment portfolio, the characteristics of the *mudarabah* contract would arguably tend to produce goal congruence rather than conflict of interest between the two parties, notably because the IAHs can "vote with their feet" and withdraw their funds if dissatisfied with their return. Through the *mudarib* share of profit mechanism, shareholders stand to gain from any profit earned from investing IAH funds. The *mudarib* share of profit constitutes a valuable source of earnings to shareholders, particularly as it is a reward for the managerial effort of the bank that shareholders earn without (in principle) incurring any risk to their equity. This suggests that in order to maintain their return from this source

of earnings, shareholders would have an interest in employing a management performance measure whereby the management of the bank would be expected to achieve a satisfactory rate of return on IAH funds – that is, a rate commensurate with the market rate of return earned by financial instruments having a similar level of risk. Achieving this would tend to motivate the existing IAHs to maintain their investments with the bank, as well as to attract other potential IAHs. On the other hand, if the aggregate investment portfolio yields a negative return, then shareholders would receive a mudarib profit share of zero. This would also tend to affect negatively the returns of shareholders in future periods, because existing IAHs would be tempted to shift to other investment opportunities and potential IAHs would be discouraged from investing in the bank.

However, Archer et al.'s hypothesis involves an assumption that shareholders have the ability to exercise the type of effective control of the bank's management that would serve to safeguard IAH interests. According to Shleifer and Vishny (1997), there are a number of corporate governance mechanisms which suggest that such an assumption is problematic. This would apply in situations where there are either diffuse shareholders or concentrated ownership.

In setups where there are diffuse shareholders, management is likely to have significant discretion over the control of corporate assets. Indeed, there are a variety of factors that keep diffuse shareholders from effectively exerting corporate control. For example, there are large informational asymmetries between management and diffuse shareholders. Also, diffuse shareholders frequently lack the expertise and incentives to close substantially the information gap and to monitor management. Indeed, a cursory review of the financial reports of Islamic banks reveals that diffuse shareholders as well as IAHs get a minimum amount of disclosure of information about the actual returns to IAHs and the extent to which the returns paid out are subjected to smoothing, the risk profile of the assets in which their funds are invested, and other relevant information that would help them in their decision making. In addition, managements of Islamic banks have significant discretion over the control of IAH assets, particularly in the case of unrestricted IAHs.

Furthermore, management may capture the board of directors because the board does not often represent the interests of diffuse shareholders. Indeed, "as ownership becomes more diffuse, managers can more easily manipulate information, form alliances with different groups, and capture control of the firm" (Caprio and Levine, 2002:5). This also has an effect on the extent to which the corporate governance problem can be solved by the use of incentive contracts. In the case of Islamic banks, it is uncertain whether the board of directors would represent the interests of IAHs. Rather, it is more likely that the board would cater for the interests of the shareholders, who normally have representatives on the board. For example, Bahrain Islamic Bank disclosed in its 2003 annual report that it will no longer allow its IAHs to share in the returns generated from investing funds available from current accounts, as was the case in the past, because this is the exclusive right of the shareholders who bear the risk while the IAHs do not. (A share of such returns may have been paid to IAHs in the past when management felt that otherwise their level of return would be uncompetitive.)

Islamic banks tend to be opaque about the bases on which management incentive contracts are established: is it on the total investment income earned by the bank before the allocation to IAHs of their share in that income, or is it the investment income (including the *mudarib* share) earned for the shareholders? If it is the latter, which is most likely the case, then management would have an incentive to manipulate that amount in order to maximize it (and, hence, their incentive pay), which would also coincide with the interests of the shareholders.

On the other hand, if ownership is not diffuse, while large investors have the incentive to collect information, to monitor management, and to exert control over managerial decisions, these activities have their cost, too, and are not without their drawbacks. As Shleifer and Vishny (1997) point out, large investors act in accordance with their own interests, which may be at the expense of other investors and stakeholders. This could also have unfavorable consequences on the firm's resource allocation. In addition, large investors are likely to get preferential treatment at the expense of other investors and stakeholders. They may influence dividend policy or cause the firm to engage in related party transactions, in ways that benefit them to the detriment of the firm's other shareholders (Dann and DeAngelo, 1985) and IAHs.

Such actions are also mirrored in the behavior of some Islamic banks. For example, we have observed instances of the following. There are Islamic banks that have attempted to pay shareholders a constant high rate of dividends for a long period, while IAHs in those banks were receiving minimum returns. This apparently was due to manipulation of the formula by which profits were allocated between IAHs and the shareholders, and of the manner in which certain expenses were charged to IAHs. In addition, in certain Islamic banks, management tend to please the board of directors, which is controlled by a few large shareholders, by "cherry picking" the more attractive projects (in terms of risk and return) for investment mainly from shareholders' funds, while IAH funds are used to finance inferior projects. This type of behavior by management appears to be influenced by the timing of the renewal of management's contract – a matter in which common shareholders, but not IAHs, have a say. These factors can have as a consequence a rate of return on unrestricted IAHs funds that is only about 10% of the rate of return on shareholders' funds.

Another issue concerned with shareholders (through management) being benefited at the expense of IAHs relates to what are known as the profit equalization reserve (PER)<sup>19</sup> and the investment risk reserve (IRR),<sup>20</sup> the purpose of which is to smooth IAH income and cover IAH losses, respectively. In the contract that regulates their relationship with the bank, IAHs agree in advance on the proportion of their income that may be allocated to both reserves, which is determined by the management of the bank at their own discretion. In the same contract, IAHs also agree to give up any right they have to these reserves when they terminate their contractual relationship with the bank. It should be noted that before AAOIFI promulgated its Financial Accounting Standard No. 11, Provisions and Reserves (AAOIFI, 1999b), no Islamic bank had disclosed information in its annual report on the smoothing of IAH profits (or covering of losses) or by how much.

Prior to the development of the concept of the PER, Islamic banks used to enhance the returns of IAHs to match the competitive returns in the market by donating the amount needed to smooth the returns of IAHs from the bank's *mudarib* share. The low rate of return on IAH funds could be due to the investment of these funds in assets with a relatively long maturity (for example, *murabahah* or *ijarah*) with a fixed rate of return that falls short of the rate currently available in the market on comparable instruments, a circumstance analogous to an adverse interest rate mismatch in a conventional bank.

The shareholders' decision to agree (which is a Shari'ah condition) to give up part or all of their profits to enhance IAH returns means that the shareholders accept that the risk attaching to the returns of a portfolio of assets financed partly or wholly by IAH funds is "displaced" so that it is borne largely by themselves (the shareholders).<sup>21</sup>

(In the case of conventional deposits, the risk of the assets in which the depositors' funds are invested is, of course, borne by the shareholders.) Failure to smooth the IAH returns might result in a volume of withdrawals of funds by IAHs large enough to jeopardize the bank's commercial position. On the other hand, smoothing the IAH returns is unlikely to attract adverse attention by the banking supervisor, because it would reduce the danger of the bank being a source of systemic risk through a run by IAHs. Indeed, in some countries (for example, Qatar and Malaysia) the banking supervisor takes the view that Islamic banks should not allow unrestricted IAHs to suffer a loss of their capital or a major fall in their returns. In this sense, the displacement of risk on to the shareholders might be thought of as being, in part, a type of "political cost" which shareholders incur in order to avoid falling foul of the industry regulator. While this practice may occur in relation to the funds of restricted as well as unrestricted IAHs, it is particularly problematic in the case of the latter whose funds are commingled with those of the bank's own (common shareholders') funds.

Such a practice might be considered to support the "vicarious monitoring" hypothesis suggested by Archer et al., in the sense that shareholders are willing to sacrifice part or all of their mudarib share in the short term in order to compensate IAHs for an inadequate level of return on the assets in which their funds are invested. This would have the effect of encouraging the IAHs to continue investing their funds with the bank because (as pointed out by Al-Dechani et al., 1999) such continuity is very much in the interest of the shareholders, particularly if unrestricted IAH funds represent 60% or more of the funding side of the bank's balance sheet, which is the case with many Islamic banks.

It was in order to mitigate the effects of this practice, which could not be sustained in the longer term if the shareholders had consistently to forgo the bank's mudarib share, that the management of many Islamic banks introduced the PER. While the declared objective of the PER was to reduce the volatility of IAH returns, it provided management with a mechanism to tap this pool of funds to relieve shareholders of the burden of smoothing the returns of IAHs or to mitigate problems of asset–liability management. In fact, as with earnings management techniques in general, a major objective is to reduce transparency and management accountability, <sup>22</sup> in this case to the detriment of IAHs, since while the amount by which the returns of IAHs are smoothed from the PER creates value for shareholders.

it does not do so for IAHs (Archer and Karim, 2004). In fact, it represents a cost (in terms of foregone returns while the reserve is being built up) which IAHs incur if they invest their funds under a form of *mudarabah* contract that permits management to retain a proportion of the profit share that would otherwise have been payable to them in order to build up a PER.

Similar considerations apply to the IRR. In addition, the IRR may give rise to moral hazard problems similar to those arising from deposit insurance schemes, since the existence of IRR in Islamic banks is likely to encourage management to engage in excessive risk taking. This is because losses can be covered, at least in part, by this reserve, which is financed only from the funds of IAHs and not those of shareholders, and this is likely to increase the management's risk appetite to a higher level than that of the IAH, especially as the IRR is appropriated from profits after the calculation of the mudarib share, which is unaffected, while in the case of a loss the mudarib share is zero irrespective of the size of the loss. Even if a loss absorbed by the IRR were due to misconduct and negligence, in which case according to the mudarabah contract it should be borne by the shareholders, it would be difficult for IAHs to be aware of this because of the absence of either adequate disclosure or other means to detect such a loss. In addition, as noted above, it is unknown to what extent the legal system in the countries in which Islamic banks operate would support the right of IAHs to be compensated for such losses in such cases. The criteria for proving negligence may be hard to satisfy, and the same may be said of misconduct if there is no clear breach of contract.

Hence, while the lack of any governance structure in the mudarabah contract may leave IAHs dependent on shareholders to monitor the performance of the management of the bank, the existence of PER and IRR is likely (and is arguably intended) to conceal from IAHs lapses in that performance, and more generally the need for them to seek other corporate governance mechanisms. In fact, the result of smoothing the returns and absorbing losses through these reserves has the effect of making the returns on IAHs behave more like those on conventional deposits – that is, a debt instrument. This effect will likely continue as long as there are adequate balances in both reserves to reduce the volatility of the returns of these account holders and to act as a buffer to absorb losses before they are seen to erode the equity of IAHs. Such a situation is furthermore sustained by, and also contributes to, both weak market discipline, which tends to exist in almost all countries in which Islamic banks operate, and a lack of

transparency (which is a common feature of banks in general, and of Islamic banks in particular).

Another implication of the PER (and of the lack of transparency) is that it would distort competition among Islamic banks, in the sense that IAHs would not see the need to withdraw their funds, which is the only means available for them to discipline Islamic banks, as long as IAHs receive a (smoothed) rate of return on their investment that is commensurate with the going market rate. Furthermore, the existence of IRR would reduce the ability, if not the incentives, of IAHs and shareholders to monitor the bank's performance, and thus would negatively affect market discipline. This is similar to one effect of deposit insurance schemes, which is to reduce the incentives of depositors to monitor banks, while subordinated debt holders, to the extent that they believe the existence of central banks as lenders of last resort might protect them, also have their incentive to monitor the bank curtailed (Caprio and Levine, 2002).

The theme emerging from the foregoing analysis of corporate governance of Islamic banks suggests that, although the management owe IAHs a fiduciary duty similar to that of shareholders, the rights of the former are likely to be compromised because of their weak governance rights and structure compared to the shareholders, even though both are equity holders and residual claimants in the bank. Furthermore, although IAHs may depend to some extent on shareholders to safeguard their interests, the above analysis suggests that such reliance has significant limitations so that, far from serving the interests of IAHs, and particularly those of unrestricted IAHs, current practice in profit smoothing and the use of reserves for that purpose involve a lack of transparency that aggravates their exposure to conflicts of interest and inhibits the development of market discipline.

Indeed, the current status of unrestricted IAHs appears fundamentally anomalous from a corporate governance perspective. Not merely is "vicarious monitoring" unlikely to be very effective, for the reasons just explained, but in the circumstances in which it is most likely to be effective – that is, full commingling of shareholders' and IAH funds – there is also the greatest likelihood of conflicts of interest regarding risk appetite. However, such limitations seem not to have affected the magnitude of IAH funds in Islamic banks, in some of which they represent a high percentage compared to other sources of funding (see Exhibit 2 in Al-Deehani et al., 1999).

In effect, unrestricted IAHs seem to behave very much like depositors in conventional banking, rather than like a category of equity

investors: they are passive and risk-averse, being content with very modest rates of return compared to those available to shareholders. But they do not have the status of creditors and the attendant governance rights in case of default. In fact, it is not even clear what would constitute default in regard to the Islamic bank's obligations to them; this would seem to be restricted to cases of misconduct or negligence, as mentioned in Section 2 above.

With this background, the next section examines the extent to which IAHs could impose effective market discipline on Islamic banks, and insofar as the abilities of IAHs to achieve this objective are limited, Section 5 discusses the approach to the regulation of Islamic banking that may be relevant in light of the initiative taken by a number of central banks and monetary agencies to develop prudential and supervisory standards that cater for the specificities of Islamic banks.

### 4. EXERCISING EFFECTIVE MARKET DISCIPLINE ON ISLAMIC BANKS

The BCBS's Revised Framework (BCBS, 2004, commonly known as Basel II) has taken the view that market discipline is increasingly important in a world where banking activities are becoming more and more complex. This view is reflected in Pillar 3 of Basel II, which encourages greater bank disclosure to strengthen market discipline.

According to Crockett (2001:3), for market discipline to be effective four prerequisites have to be met: "First, market participants need to have sufficient information to reach informed judgments. Second, they need to have the ability to process it correctly. Three, they need to have the right incentives. Finally, they need to have the right mechanisms to exercise discipline" (emphasis in original). In what follows, an attempt will be made to examine the extent to which IAHs qualify for Crockett's prerequisites for imposing effective market discipline on Islamic banks.

The hypothesis suggested in Archer et al. (loc. cit.) assumes that one of the factors that would give IAHs comfort is that these investors are aware, among other things, of the commingling of their funds with those of shareholders and of the proportions in which the portfolio of assets is financed by IAHs and shareholders, respectively, and how the banks calculate the allocation of profit sharing between the two parties. However, as noted by Archer et al., these assumptions are problematic given the lack of adequate disclosure by Islamic banks

which results in major information asymmetry between IAHs and the bank's management, as described below.

Prior to the establishment of AAOIFI, the lack of adequate disclosure by Islamic banks was very apparent. This may have been due to a lack of appreciation of the financial reporting requirements with which Islamic banks should comply in order to provide adequate disclosure to IAHs in their capacity as equity investors, not depositors. Indeed, a cursory review of the annual reports of Islamic banks prior to the implementation of AAOIFI's standards reveals that Islamic banks were hardly required to disclose any information relating to the investment of IAH's funds - for example, (i) the type of assets in which the funds of these account holders are invested, (ii) the risks to which they are exposed and how the bank manages those risks, (iii) the bases of allocation of profits between the bank and IAHs. including the type and amount of expenses that the bank charges to their accounts, (iv) whether either of the two types of investors (IAHs or shareholders) is given priority in placing liquid funds available for investment, and (v) whether the returns of IAHs are smoothed and if so by how much, and so on.

Islamic banks were also divided as regards the accounting treatment of IAHs on their balance sheet. Some banks reported unrestricted IAH funds on the balance sheet under liabilities, <sup>23</sup> while others treated them as part of equity. Yet a third group of banks treated all IAH funds as off-balance sheet items. Karim (2001) argues that these differences were due to the approaches adopted by various countries to regulate Islamic banking.

Such a lack of transparency meant that there was considerable information asymmetry between IAHs and the management of the bank, which prevented the former from being adequately informed about the performance of their investments, and at the same time provided the management with enough freedom to favor shareholders (to whom they are accountable via the board of directors and the annual general meeting) at the expense of IAHs (particularly unrestricted IAHs) who have no such governance rights. On the other hand, with the exception of the accounting and governance standards issued by AAOIFI to enhance the transparency of matters relating to IAHs, very few regulations were promulgated by authorities in the countries that host Islamic banks to address the corporate governance issues raised by the existence of this type of equity investor. In addition, while anecdotal evidence suggests that the standards prepared by AAOIFI have created much awareness of corporate governance issues

relating to IAH, their impact has been greatly restricted by the fact that only a limited number of countries have adopted these standards, and that even in those countries compliance with them is patchy (see Mustafa, 2003).

However, to improve corporate governance for IAHs through disclosure requires a cross-sectoral approach to the regulation of the institutions that accept these investment accounts. Such an approach draws, inter alia, upon securities regulation, which requires that adequate attention should be given to *investor protection* (which does not mean a guarantee of capital, but providing investors and prospective investors with full disclosure of information, whereby they are better able to assess the potential risks and rewards of their investments and, thus, to protect their own interests).

As will be discussed later, almost all supervisors have approached the regulation of investment account holders from the perspective of depositor protection rather than investor protection<sup>24</sup> (see also Archer and Karim, 2004), and this appears to have placed the regulation of these accounts solely in the hands of the banking regulators, with hardly any involvement by the securities regulators who tend to be unaware of either the complexities or the disclosure requirements of IAHs in Islamic banks.

On Crockett's second prerequisite - namely, the need to have the ability to process the information correctly - suffice it to say that the complexities of the operations of Islamic banks are hardly understood even by many in the industry. Indeed, not many would be familiar with the inherent risks of the contracts used by Islamic banks in both the utilization and mobilization of funds. For example, until AAOIFI published its accounting standard on leasing, almost all Islamic banks - with the approval of their external auditors - invariably used to treat ijarah muntahia bittalmileek (IMB)25 as a finance lease, although according to the Shari'ah provisions of the contract the lessor is not allowed to transfer substantially all the risks and rewards of ownership to the lessee. From the perspective of the Basel II requirements, the treatment of IMB by Islamic banks prior to AAOIFI's standard would mean that the banks which entered into such a contract as lessor would be exposed only to credit risk. However, according to both the Shari'ah precepts of the contract and its substance, the bank as lessor under IMB would be exposed to a significantly higher level of operational risk than a lessor under a conventional finance lease (as well as being similarly exposed to price risk on the value of the asset as quasi-collateral, subject to "haircuts"), and hence should be expected to provide regulatory capital to cater for these risks, an issue with which not many supervisors of Islamic banks would be able to cope easily.

Another example relates to the salam contract, which exposes the Islamic bank to both credit risk and commodity price risk as the bank agrees to buy the commodity on a future date against current payment and also holds the commodity in question until the bank can convert it into cash, unless it has entered into a parallel salam contract. The latter contract enables the bank to hedge against price risk, but only partially because the Shari'ah provisions of the contract prohibit making the execution of the parallel salam contract dependent on the execution of the original salam contract. In this case, AAOIFI's Standard No. 7 on salam and parallel salam specifies that the underlying asset of the contract should be measured at lower of cost and market price when it is received by the bank. However, if the customer defaults on its obligation to deliver the commodity to the bank, the latter has nevertheless to fulfill its obligation in the parallel salam by acquiring the commodity from the market, which exposes the bank to price risk (in addition to the inherent credit risk) in the event of such default.26 On the other hand, if the bank is not allowed to enter into a parallel salam because of a Shari'ah ruling (as is the case in certain countries), it would be fully exposed to price risk on its "long position" in the asset which it would have to sell after the maturity of the contract. In this case, the asset should be measured at its fair value, a point not covered in the AAOIFI standard.

The lack of appreciation of, among other things, the intricacies of both risk management and financial reporting relating to the operations of Islamic banks by IAHs and other consumers of the Islamic banks' services, together with the lack of adequate disclosure, indicate that neither of Crockett's first or second prerequisites is satisfied in order for market discipline to be effective in the case of these banks.

Crockett's third and fourth prerequisites regarding the right incentives and mechanisms can best be addressed by looking at the similarities and differences between subordinated debt and IAH funds. There have been proposals (for example, Evanoff and Wall, 2000; Hamalainen, 2004) to ask banks to incorporate subordinated debt into their capital as an additional financial cushion, as this is "one of the most effective market mechanisms for relaying information about a bank's risk profile.... [This is because] subordinated debt holders... do not profit from a bank's risky investments if

those investments turn out to be profitable, but they stand to lose their money if those investments are not profitable. For that reason, holders of subordinated debt would have a very strong incentive to monitor closely the activities of banks" (Rodriguez, 2002;18).

IAH funds share several features of subordinated debt, including, most importantly, the subordination of their claims to those of creditors. Also, unlike conventional depositors, neither holders of subordinated debt nor IAHs are in a position to initiate a conventional bank run, and stand to lose part or all of their capital if their investments vield negative returns. This provides holders of both instruments with incentives to monitor the bank's choice of risk, especially as both instruments may be used as a means of leveraging the shareholders' returns (in the case of IAHs, because of the mudarib share of profits - see Al-Deehani et al., 1999). IAHs are entitled to profits that are related to the investment of their funds, which may or may not be commingled with the bank's own (shareholders') funds. If IAH funds are commingled with shareholders' funds in the same pool of assets, they are likely to constitute the larger share of the investment in the asset pool, but the choice of asset allocation may reflect management's view of shareholder preferences in terms of risk-return characteristics. Hence, there is always an incentive for the management of both conventional and Islamic banks to increase risk through leverage using subordinated debt or IAH funds, respectively, because the shareholders in both types of banks will benefit fully when the banking business is successful. Shareholders may benefit more from the "upside" of risk to which there is no firm upper bound, but may not be exposed proportionately to the "downside" which is limited to the loss of their capital.27 In certain circumstances, such as incipient financial distress, this may provide management with a motive for taking excessive risks (that is, "betting the firm").

In case of a bank failure, the losses of the shareholders in both types of banks are limited to their share in the bank's capital, and holders of subordinated debt in conventional banks have a claim on the assets of the banks that ranks after those of other creditors but before that of shareholders. Unrestricted IAHs, on the other hand, rank after all creditors but pari passu with the shareholders in respect of commingled funds.

However, in contrast to holders of subordinated debt, IAHs lack a mechanism whereby they contribute significantly to effective market discipline – namely, a *quoted market price* that reflects the market's view of the bank's financial position. Subordinated debt bonds are

tradable in the financial markets and their yields provide the market's assessment of the risks taken by the banks. "This implies that the supervisor will get an early warning signal, either through a higher required risk premium by the investors or though trouble when issuing new bonds. So the holder of the bond will have the incentive to monitor the bank continuously, strengthening the market discipline" (Sijben, 2002:61). These mechanisms, however, are not available to IAHs because their investments are not tradable in the capital markets. Hence, IAHs lack this means of signaling to the market their assessment of the risks taken by the Islamic bank and thus putting pressure on the bank's management via the capital market as indicated above.

Furthermore, while IAHs, like any investors, are expected to monitor the bank's choice of risk because their capital is exposed to losses, the lack of adequate disclosure of relevant information makes this a difficult task for IAHs, thereby further reducing their ability to exercise effective market discipline. This may encourage Islamic banks to increase their risk to a level in excess of the risk appetite of IAHs, especially since the latter are not in a position to require a higher risk premium on their investment; their only recourse is to withdraw their funds, subject to a loss of accrued profit share if they do not observe the waiting period set out in their mudarabah contract.

In addition to the availability of adequate information to gauge the riskiness of the bank by depositors, Blum (2002) and Cordella and Yeyati (1998) argue that a conventional bank's risk choice will be efficient if the bank deposits are uninsured. This is so because banks take account of the impact of their risk choice on depositors, since they will demand higher compensation should the bank incur higher risk. However, if deposits are insured or the bank's risk choice is not observable by depositors, the bank will increase risk at the expense of depositors (Baumann and Nier, 2003).

Although contractually IAHs are uninsured because they bear their own risk of loss, the use of an IRR by Islamic banks may have "safety net" effects for IAHs which reduce their incentives to monitor management. 28 Furthermore, in a number of countries, including some that have a high density of Islamic banks (for example, Bahrain and Sudan), Islamic banks enjoy the benefits of a formal system of Shari'ah-compliant (that is, takaful-based) deposit insurance. The introduction of deposit insurance is, however, contrary to what is recommended in a report by the World Bank (2001) which calls for developing countries that do not have a formal system of deposit

insurance to refrain from establishing one, especially if the institutional environment in that country is weak. In addition to these safety nets, the availability of PER tends to reduce the incentives of IAHs to exercise market discipline because, as argued earlier, they would not see the need to withdraw their funds as long as they receive a smoothed rate of return on their investments that is commensurate with the market rate. However, while these measures may potentially curb the incentives of IAHs to monitor the bank's risk choice, they also tend to provide Islamic banks' management with the opportunity to take excessive risk.

From the analysis in this section, it can be realized that given their lack of a governance structure, unrestricted IAHs hardly meet Crockett's four prerequisites which enable them to impose effective market discipline on Islamic banks. This highlights the emphasis that should be placed on regulating Islamic banks, which is examined in the next section, in order to enhance, among other things, the corporate governance in these banks with a view to protecting the interests of IAHs.

### 5. REGULATION OF ISLAMIC BANKS

In almost all cases, Islamic banks are regulated by the central banks in the countries in which they operate. However, there is an absence of commonly accepted regulatory and supervisory guidelines and best practices that cater for the specificities of Islamic banks - for example, the treatment of IAHs in calculating the bank's capital adequacy ratio (see, for example, Karim, 1996; AAOIFI, 1999c), the risk weightings of the Shari'ah contracts which the banks use to utilize their funds, and so on. Accordingly, central banks have tended to supervise and regulate Islamic banks using the same guidelines as those developed for conventional commercial banks, albeit with some amendments that were introduced by individual central banks.29 However, in doing so, central banks seem to have adopted an approach that emphasizes depositor protection rather than a cross-sectoral approach that combines both depositor and investor protection to cater for the commercial banking and investment management services which Islamic banks perform.

Contractually, since IAHs bear their own risk of loss, it would not be expected of central banks to protect the equity of these investors by the same methods which they use for depositors such as current account holders who lend their money to the bank and have a contractual right to redeem their funds in full as and when they demand to do so. Hence, like investors in collective investment schemes, IAHs should logically be regulated using the approach of securities regulators which is more concerned with investor protection and places more emphasis on fiduciary responsibility or establishes detailed regulations designed to monitor potential conflicts of interest for the management of an Islamic bank, which may look after the interests of shareholders at the expense of IAHs. In addition, securities regulation would require disclosure of relevant information about the Islamic bank's investment objectives and policies, and operational guidelines that govern the relationship between the bank and IAHs. This would allow IAHs to be in a better position to assess the potential risks and rewards of their investments and, accordingly, to protect their own interests.

However, such an approach to regulation would place the central banks concerned in a dilemma. On the one hand, adopting a securities regulation approach would give a faithful representation of the contractual relationship between IAHs and the bank, and at the same time give IAHs an incentive to exercise effective market discipline on the bank's management. On the other hand, insofar as IAHs have deposited their funds in the bank rather than investing them in a collective investment scheme, the expectation would be that if IAHs are paid no returns on their investments or low returns compared to the market return of similar instruments and are made to bear the risk of loss, they may move to withdraw their funds, leading to a liquidity crisis for the bank that could have effects similar to those of a conventional bank run.

Such an action would be of great concern to central banks, because not only may this threaten the bank's solvency, but it could also trigger systemic risk (which is considerably less evident or non-existent for the non-banking financial sector – see, for example, Llewellyn, 1999; Dale, 1996) in the whole banking sector, thereby threatening the soundness and stability of the financial system in the country. Hence, in order to mitigate such rate of return risk and investment risk, central banks have allowed Islamic banks to use PER and IRR, which, as argued earlier, tend to weaken market discipline, and in some countries have encouraged or even required Islamic banks to treat unrestricted IAHs as (in substance) capital certain.

It is worth noting that, as with many of their conventional commercial counterparts, the portfolios of assets of the majority of Islamic banks are non-marketable and are typically held on the balance sheet until maturity.<sup>30</sup> Hence, unlike the majority of collective investment schemes, many Islamic banks would not be able to liquidate the majority of their assets in a short time, without incurring substantial (and possibly catastrophic) losses.

#### 6. CONCLUDING REMARKS

This chapter has argued that the profit-sharing and loss-bearing features of IAHs raise specific problems of regulation with respect to Islamic banks. To a considerable extent, IAHs resemble collective investment schemes, yet, particularly in the case of unrestricted IAHs, their funds are managed within a banking structure by virtue of a mudarabah contract which places no "firewalls" between the investment funds and the bank. Unrestricted IAHs are thus a form of limited-term equity investors in an Islamic bank, but have no governance rights other than that of withdrawing their funds (which has the disadvantage of entailing the forfeiting of accrued profit share). Moreover, to minimize the likelihood of their doing this, Islamic banks employ various profit-smoothing techniques, which (like earnings management in general) have the effect of frustrating market discipline.

However, insofar as both Islamic banks and their supervisory authorities in some countries consider unrestricted investment accounts to be a product designed to compete with, and to be an acceptable substitute for, conventional deposits, profit smoothing in such an environment may be considered to be an inherent attribute of the product rather than a means of deliberately avoiding transparency and market discipline, especially if it is combined with in-substance capital certainly. Indeed, as noted above, in some such countries unrestricted IAHs may benefit from deposit guarantee schemes. Nevertheless, the compliance of some of such practices with Shari'ah rules and principles seems open to doubt, to say the least. Moreover, the desire to offer as good a substitute as possible for conventional deposits does not justify obfuscation or a lack of transparency in financial reporting.

The implications of this analysis for financial services regulators are therefore twofold. In the first place, more emphasis needs to be placed on the need for transparency. Considerable improvements in transparency could be achieved by the effective enforcement of AAOIFI's financial reporting standards, which need to be updated on a timely basis as both industry practices and the IASB's international financial reporting standards evolve. Second, IAHs need to be considered as

investors in need of regulatory protection as such – that is, *investor* protection. Alternatively, if unrestricted IAHs are considered to be *virtual depositors*, the implications of this in terms of *capital adequacy* need to be enforced by the supervisory authority – namely, the treatment of unrestricted IAHs in the same way as liabilities for the purpose of calculating the capital adequacy ratio.

What is clearly unacceptable is that investment accounts which are juristically profit-sharing and loss bearing should be left with an ambiguous status that allows Islamic-banks to finesse transparency, capital adequacy, and investor protection requirements in respect of such financial instruments by treating them as virtual deposits for marketing purposes but as equity instruments (or even off-balance sheet) for the purpose of capital adequacy, while financial services regulators do not consider them as calling for measures of investor protection.

#### **ENDNOTES**

- The views expressed in this chapter are those of the authors and do not necessarily represent those of the Islamic Financial Services Board or of any other organization.
- Shari'ah is the sacred law of Islam. It is derived from the Qur'an (the Muslim holy book), the Sunna (the sayings and deeds of Prophet Mohammed), ijma' (consensus), qiyas (reasoning by analogy), and maslahah (consideration of the public good or common need).
- <sup>2</sup> Riba is translated strictly as usury, but interpreted by modern Islamic scholars as being equivalent to interest (see Mallat, 1988; Saleh, 1992; Taylor and Evans, 1987).
- The original form of the mudarabah contract is very similar to that of the commenda contract in general use by Italian and other merchants in the late Middle Ages and early modern period (see Bryer, 1993; Cizakça, 1996).
- Murahahah is sale at cost plus an agreed-upon margin of profit; musharakah is a form of partnership; ijarah is leasing; and salam is a purchase of a commodity for deferred delivery in exchange for immediate payment. For more details on these and other contracts, see Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (2002a).
- Franks et al. (2003) report that in the seven European countries that they surveyed, the regulatory authorities require asset management firms to separate their assets from those of their clients.
- <sup>6</sup> For a comprehensive coverage of these details see, for example, Udovitch (1970) and Vogel and Hayes (1998).
- 7 It is worth noting that in order for an asset to be reflected on the balance sheet of an Islamic bank, AAOIFI (1993:para. 22) requires, among other things, that "the Islamic bank should have acquired the right to hold, use or dispose of the asset."
- In this respect (but not in others) they resemble "puttable stock"; however, the put option is usually not absolute, but subject to the bank's agreement to its exercise.

- This is similar to the practice by many mutual funds firms which prohibit or discourage market timers (investors who rapidly trade in and out of mutual funds) because it is claimed that this hurts buy-and-hold shareholders as the fund manager has to keep extra cash ready to pay the exiting market timer, which dampens performance. Islamic banks reward IAHs who invest their funds with the bank for a longer period by allocating them a higher profit ratio compared to the profit ratio allocated to IAHs who opt to have access to their funds on demand or invest them for a short period because the bank, like fund managers, has to make cash available to meet withdrawals by these IAHs.
- This is a part-time board comprising (usually) three Shari'ah scholars appointed (in many cases) voluntarily by almost every Islamic bank to assure its clients (mainly those who are keen to have their funds managed in accordance with Shari'ah rules and principles) that its transactions are in compliance with Shari'ah precepts. For more information on this board, see AAOIFI (1999a).
- According to Saleh (1992:134), "The reason for the unacceptability of the agent's [mudarib] guarantee is that such an agent, likewise any partner, is considered a trustworthy party (amin) with respect to the capital remitted to him. He is therefore not liable for any loss occurring in the normal course of business activities, except when there is a breach of trust." However, although "the capital provider is permitted to obtain guarantees from the mudarib [to which the former can have recourse] ... in cases of misconduct, negligence or breach of contract on the part of the mudarib" (AAOIFI, 2002b), this seems not to be practiced by Islamic banks in their current dealings with IAHs.
- The Shari'ah provides that, in case of proven misconduct or negligence on the part of the mudarib in a mudarabah contract, the funds become a liability of the mudarib. Not merely does this not cover normal cases of default; it taises significant problems of enforcement for example, in proving misconduct or negligence.
- 13 For more details, see Al-Deehani et al. (1999).
- 14 For other types of restrictions, see AAOIFI (1993:paras 12, 13).
- 15 Shareholders receive the profit generated from investing the other sources of funds because, in case of loss, providers of these funds are compensated from the shareholders' equity.
- 16 For more details see Udovitch (1970) and AAOIFI (1996; 1997).
- 17 See, for example, Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd. (2004, EWCA Civ. 19) which did not concern "misconduct and negligence" but the application of a murabahah contract where U.K. law was stipulated as the governing law.
- According to Udovitch (1970:171), "the investor [IAH] might calculate that a larger total sum in the venture would increase the opportunities of profitable trading activities, or he might feel that the agent's [Islamic bank's] direct financial stake in the transactions would make him at once more cautious and more enterprising." See also Al-Dechani et al. (1999) for more details on the theoretical underpinnings of this proposition, and also Williamson (1996) on "hostage posting."
- PER is an amount set aside from the income of both IAHs and shareholders before the allocation of the bank's share as a mudarib. The IAHs' share of the PER is used to smooth the profit of IAHs to match the returns of instruments in the market, thereby encouraging IAHs to retain the funds with the bank to manage

- them on their behalf. The shareholders' share of the PER is a component of the reserves within the shareholders' equity (AAOIFI's Financial Accounting Standard No. 11, Provisions and Reserves (1999b)).
- 20 IRR is an amount set aside from the income of IAHs, but not the shareholders, after the allocation of the bank's share as a mudarib to absorb losses attributed to investments financed by IAHs before the losses affect the equity of IAHs. Shareholders cannot contribute to this reserve because this is considered as indirectly compensating IAHs for losses, which is strictly prohibited by the mudarabab contract.
- 21 See Archer and Karim (2002).
- <sup>22</sup> A related objective is to impede market discipline; see Section 4 below.
- While clearly incorrect from a juristic point of view in Shari'ab, such a treatment (combined with the "income smoothing" described in the preceding section), is at least consistent with the tendency of Islamic banks in some countries to consider unrestricted IAHs as close substitutes for conventional deposits (see Archer and Karim, 2004).
- 24 As indicated in Section 3 above, the behavior of unrestricted IAHs may be considered to provide a rationale for such an approach. See, however, our comments in Section 5 below.
- 25 This is a lease contract that ends up with the transfer of ownership of the leased asset from the lessor to the lessee.
- See Sundararajan (2004) for more detailed discussion of risks in Islamic banking.
- 27 In effect, they hold a "call" option over the bank's assets that they will exercise only if the value of those assets is greater than the amount of other claims on the assets that rank as senior to theirs.
- According to Franks et al. (2003:11), in the European countries which they surveyed, "If parent firms believe that either the intrinsic value of their asset management firms or the loss of their own reputations outweigh the cost of compensating investors, they will protect investors against loss."
- 29 The only exception seems to be the regulatory framework that was developed by the Bahrain Monetary Agency.
- Accounts receivable that result from sale of assets on a deferred payment basis for example, murababah and salam represent in the majority of Islamic banks the highest percentage of total assets. With the exception of Malaysia, in almost all other countries Islamic banks follow the Shari'ah ruling that does not allow the sale of debt except for the same amount. Hence, an Islamic bank is unlike an asset management company, since if an asset management company collapses and the investor funds are held separately from the company's own assets, portfolios under management can be transferred at a low cost from that asset management company to another (Franks and Mayer, 1989; Dale, 1996).

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## Corporate Governance and Supervision: Basel Pillar 2

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### 1. INTRODUCTION

The revised framework for measuring capital adequacy (Basel II) was published as the outcome of the deliberations of the Basel Committee on Banking Supervision (BCBS) to secure international convergence on revisions to supervisory regulations governing the capital adequacy of internationally active banks. Under Basel II, the BCBS sought to create a more risk-sensitive capital adequacy framework by introducing operational risk as well as a more sophisticated approach to credit risk, together with market risk (introduced by the 1996 Market Risk Amendment to the original 1988 Basel I framework), into the calculation of the minimum capital requirements, under the first of three "pillars." The BCBS emphasizes that it is critically important that the minimum capital requirements set by the first pillar be reinforced by banks' rigorous assessment of their capital adequacy and their supervisors' review of such assessment under the second pillar.<sup>2</sup>

Basel II provides the senior management with an incentive to put in place systems and controls to monitor, measure, and mitigate risks as a matter of good governance, as better risk management practices will lead to a lower level of capital that the firm is required to maintain.<sup>3</sup> It is the responsibility of banks to develop an internal capital assessment process and set capital targets that are appropriate for their risk profile and control environment.<sup>4</sup> However, supervisors are expected

to evaluate how well the banks assess their capital requirements relative to their risk and to intervene where appropriate. Such a process is intended to foster "an active dialogue between banks and supervisors" whereby the supervisor can be proactive, ather than merely reactive. Banks are therefore advised to implement procedures for regular monitoring of operational risk profiles and material exposures to losses and for regular reporting of pertinent information to senior management and the board of directors that supports the proactive management of operational risk. Indeed, it is the BCBS's view that each bank's board of directors and senior management have an obligation to understand the risk profile of the bank and to ensure that capital levels adequately reflect such risk.

This chapter considers corporate governance from the perspective of the banking supervisor, in the light of Basel Pillar 2, with particular reference to the context of Islamic finance. The remainder of the chapter is structured as follows. Section 2 recalls the four "key principles" of supervisory review as set out in Pillar 2. The implications of Pillar 2 for corporate governance are reviewed critically in Section 3, with reference to the treatment of risk, including operational risk, Given that Pillar 2 calls for the evaluation of corporate governance, Section 4 is concerned with the problems of evaluating the quality of corporate governance. Section 5 focuses on operational risk, and in particular with "accounting" for such risk, by which we mean the proper identification and evaluation of risk for the purpose of managing it effectively. Legal risk, as part of operational risk, is considered in Section 6, with particular reference to the danger of over-reacting to certain types of threat. Section 7 examines legal risk from the perspective of the creation of a viable international Islamic financial system. The concluding Section 8 considers future developments, with particular reference to securitization as a key aspect of the future of Islamic finance.

# 2. KEY PRINCIPLES OF SUPERVISORY REVIEW

In reviewing how the banks assess their capital requirements, the BCBS has identified four key principles for supervisors to follow. The first principle is that "banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels." Under this principle, board and senior management oversight, sound capital assessment,

comprehensive assessment of risks, monitoring and reporting, and internal control review are identified as the main features of a rigorous process. 12 The BCBS emphasizes the importance for supervisors of understanding how corporate governance affects a bank's risk profile. 13

Bank management is responsible for ensuring that appropriate risk management processes are in place, taking into account the nature and level of risk that the bank is exposed to and the resultant adequate level of capital for the risk exposure. Indeed, senior management and the board should view capital planning as a crucial element in being able to achieve its desired strategic objectives. <sup>14</sup> The BCBS considers it to be the responsibility of the board of directors to approve and oversee the bank's strategic objectives and corporate value, which are communicated throughout the banking organisation. <sup>15</sup>

Board members should be qualified for their positions, have a clear understanding of their role in corporate governance, and be able to exercise sound judgment about the affairs of the bank.\(^{16}\) Among the tasks that the Committee expects the board members to perform, those pertinent to the present discussion of risk management are the understanding and oversight of the bank's risk profile and the approval of the bank's overall business strategy, including the risk policy and risk management procedures. Furthermore, the board members are expected to meet regularly with senior management and internal audit to review policies, establish communication lines, and monitor progress toward corporate objectives, and to promote bank safety and soundness, understand the regulatory environment, and ensure that the bank maintains an effective relationship with supervisors.

# 3. PILLAR 2 AND ITS IMPLICATIONS FOR CORPORATE GOVERNANCE

The criticism has been made that the rules under Basel II will "shift the regulatory regime toward a highly complex, formula-based system, and will diminish the important role that is currently played by human judgment. Implementation of these rules will be high cost, but not highly cost effective." <sup>17</sup> Indeed, it has also been pointed out that most banks will need to overhaul their internal risk management and governance processes in order to comply with the second pillar which sets standards for internal management and reporting structure equivalent to international "best practice." Such review and revision

of governance process are expected to take years to complete and to cost millions. 18

From the point of view of the regulated banks, there is currently much uncertainty as to what procedures and measures need to be put in place to meet the regulatory requirements that will be implemented in each country based on Basel II, notwithstanding the large number of countries that are expected to adopt it.19 It is, after all, up to the supervisor to determine whether the bank meets the capital requirements. Under the second of Pillar 2's key principles for supervisory review, supervisors are expected to review and evaluate banks' internal capital adequacy assessment and strategies, and their ability to monitor and ensure their compliance with regulatory capital ratios. If they are not satisfied with the outcome of such review and evaluation, supervisors can take appropriate supervisory action by requiring banks to hold capital in excess of the minimum.20 Indeed, supervisors are expected to intervene at an early stage to prevent capital from falling below the minimum required level and to require from the bank in question rapid remedial action if capital is not maintained or restored.21 The BCBS maintains that supervisors should have the discretion to use the tools best suited to the circumstances of the bank and its operating environment.22 The BCBS does not see the provision of an increased level of capital as the only and permanent solution to banks' difficulties, but as an interim measure while more permanent solutions such as enhanced systems and controls are being put in place.23

It is not surprising that the guidance and recommendations of the Committee, comprising senior representatives of bank supervisory authorities and central banks of 13 leading economies around the world, are devised from the supervisors' perspective. However much the BCBS extols the virtues of good governance that takes account of the bank's risk profile,<sup>24</sup> the Committee does not, on the whole, provide much guidance for the bank that needs to comply with the new, more risk-sensitive regime for capital requirements when it is implemented. The BCBS itself accepts that not all risks can be measured precisely, but takes the view that a process should be developed to estimate risks.<sup>25</sup>

One of the most pressing issues for the banks is the introduction of operational risk into the framework and the consequential provision of capital reflecting that risk. The BCBS defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition

includes legal risk, but excludes strategic and reputational risk\*26 (emphasis added). The Committee further defines legal risk by stating that it "includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.\*27

Indeed, to appreciate the significance, to the governance and management of banks, and, in particular, Islamic banks (which may not meet the legal definition of banks in some countries but perform a similar economic function), of the introduction of operational risk and its inclusion of legal risk, it is the issues at micro level that we need to turn to.

# 4. THE QUALITY OF CORPORATE GOVERNANCE

As we have seen, an essential feature of corporate governance is putting in place systems that are capable of demonstrating that general and specific risks to the enterprise are identified and addressed in a manner that is acceptable in terms of the law, current business morality, and good sense. There is little, at least in traditional notions of governance, whether characterized as "good governance" or not, that in themselves actually prescribe a "good" result or outcome. The beneficial situation, which it is desired to achieve, is to be attained through adherence to demonstrable procedures. It is the procedures that, if properly complied with, are assumed to produce (because of a host of factors, but largely as a result of transparency) a good result.

The issues so raised recall the debate in jurisprudence that centered on the inability of the proponents of natural law to identify a pervading justification for their "ultimate good" as a source of law, other than through some process of a priori and highly subjective reasoning. Some jurists strove to answer the skepticism of the pragmatic positivist schools by devising a series of essentially procedural tests of what law is. 28 These invariably reflected subjective criteria of what is good, such as effective promulgation, absence of arbitrary discrimination, and certainty of application, but they nonetheless provided what at least appear to be objectively verifiable tests. In other words, the analysis is transferred from the end to the means, with the hope that specified means will result in "good" ends. 29

Of course, any process that depends upon procedures requires not only that the relevant procedures be properly adhered to, but that there should be some "control factor" at work supporting the efficacy of the procedures. For example, transparency cannot be a justified end in itself. The costs and risks associated with imposing additional transparency must be justified.

In the context we are examining in this book, it is possible to discern at least three roles for transparency (or, rather, disclosure for the purpose of transparency). First is where disclosure of facts facilitates "enforcement" of some other rule. A good example of this is rules that require certain insiders, such as directors, officers, and in some cases substantial shareholders, to report on a relatively timely basis dealings in the securities of their own companies. This, it is argued, may well facilitate the enforcement of other rules prohibiting insiders from abusing inside information. In some societies the mere requirement to disclose conduct that would be considered anti-social may be sufficient to discourage that activity. Second, disclosure may be used to provide decision makers or those who advise them with sufficient information to reach sensible decisions. An obvious example of this is the disclosure that attends issues of new securities, but there are many others. Third, there is the use of disclosure to censure. This is associated with the use of disclosure to facilitate the enforcement of another rule. However, there are situations where the disclosure of information has a distinct "shaming" effect and itself serves as a punishment.

# 5. "ACCOUNTING" FOR OPERATIONAL RISK

Given the inherent relationship of governance to the identification and management of risks, whether inherent in a firm's commercial activities or related to the integrity of its management and personnel, and the attention that has been focused on developing effective prudential banking regulation and in particular risk control, it is not surprising that governance has been a pervading issue in the deliberations that led to Basel II. One of the issues that has received much attention, but (it has to be said) little intellectual analysis, is the need to "account" properly for risk and in particular for "operational risk." This issue is, as we have seen, at the heart of the international governance movement.

Risk is the dynamic factor in all businesses and will, to some degree, vary with the nature, extent, and location of the enterprise. Indeed, over the last 15 years or so, a veritable industry has developed,

particularly in North America and Europe, focused on the identification, assessment, and management of risk. To be sure, concern about these issues is, in fact, not as novel as perusal of the business and financial press might suggest. The insurance industry has long been concerned with these issues and it is perhaps in this area of activity that most real expertise resides.

The identification of risks and an assessment of their impact on the viability and profitability of a business venture in general or specific terms is, indeed, a pretty basic business skill. There is nothing new in the concern and probably not in the rationalization of the process. History throws up many examples of societies even institutionalizing the issues and modifying accepted rules and procedures to address exceptional or specific risk. An example that is perhaps particularly apposite in a work concerned primarily with financial business that is compliant with the Shari'ah is the willingness of early Christian communities to tolerate the charging of interest (usury) for exceptionally risky ventures such as in maritime commerce. In the ordinary course of business, usury was forbidden.

We are not able, in a work such as this, to focus on the wider issues associated with risk, whether within the scope of Basel II or in the wider world. Suffice it here to express the view that perhaps too little attention has been given, other than within the narrow confines of particular disciplines, whether actuarial or otherwise, to the analysis of the phenomenon of risk, particularly in terms of its subsidiary implications. This is particularly the case in regard to legal risk, an issue to which we will return shortly. There are those who, with some justification, have sought to distinguish a threat from the risk that ensues as a result of the threat, actual or potential. To focus on the identification of risk is therefore seen as a secondary process, which may not accord sufficient attention to the underlying threat and its proper control. The implication of risk, consequent upon a threat, will depend upon how the risk develops. The containment and control of the impact of a risk once it has occurred is a different, albeit related, process, requiring somewhat different skills.

While all this may not be particularly important in the context of the broad stroke approach to the determination of risk factors and the attendant "accounting" under Basel II, there is clear relevance in the institutions and procedures of governance. Simply to lump these issues together as risk management, and to fashion the due procedures of supervision and governance accordingly, may not be plausible even in cosmetic terms. We have seen how a similar failure to grasp the underlying analytical issues in the area of compliance has resulted in little more than cosmetic treatment being applied to some of the most unacceptable "warts" on the ugly face of capitalism (to misquote former British Prime Minister Edward Heath when speaking on a particularly controversial corporate scandal in 1973).<sup>30</sup>

That regulators are willing to ignore these issues or, rather, to connive in the "fix it" approach of governments, concerned primarily with responding to scandals and achieving an apparently credible response within the short period of their own exposure to accountability, is to be regretted. It is, however, understandable. The reality is that, on the whole, business activity is sound in terms of its ability to deal with risks, and the threats that do present real issues in terms of risk impact are few and far between. Even looking at the threat of terrorist activity, when sensibly analyzed and assessed, the possible impact for most businesses is minimal.

It is also the case that often the responses to identified threats, once established, soon become disproportionate to the risks. Take, for example, the "crusades" that have been launched, largely from Washington, in regard first to the illicit trade in drugs and then, after 9/11, to the financial activities of terrorist organizations. Once it became accepted that organized crime, particularly in the case of drug-related activity, appeared to function like any other enterprise, the argument that enforcement and then regulatory activity should be focused on the vulnerability of its financial systems became indisputable. The U.S. and its allies erected a vast complex of laws, regulations, and various procedures designed to identify and then interdict the proceeds of crime. The cost in direct and indirect terms that this has imposed on the financial system has never been more than "guestimated." However, that it is vast cannot be denied. It is also the case that the impact on transactional costs and the regulatory and compliance burden, thrown in particular on the developing and transitional economies, is wholly disproportionate to any sensible assessment of the threats posed to them.

On the other hand, these measures that the U.S. and its allies, directly and through inter-governmental organizations, have foisted on the world have had dubious success. Demand for and supply of illicit drugs have arguably not been affected. The amounts of money, actually taken out of the "criminal pipeline," are minimal and represent, in most countries, a ludicrously small proportion of the estimated exposure to "illicit" finance let alone criminal enterprise. The adoption of a similar model of control to address the financing

of terrorist organizations after the atrocities on 9/11 was entirely misconceived. While there are obviously some terrorist organizations that function in whole or part as ordinary criminal organizations and engage in enterprises that, at least theoretically, might be amenable to disruption and interdiction, in the case of many others their funding will be from non-criminal sources.

Despite imposing a regulatory straight-jacket on the financial world, which has effectively deprived certain communities of access to Western banking and greatly increased the costs in terms of compliance for all concerned, it is now admitted, even by many in Washington, that trying to identify terrorist finance in the financial system is rather like trying to catch one kind of fish by draining the ocean. Indeed, the consequences of such ill-conceived measures are not just to waste resources and cause instability in the developing and transition economies, but also to foster the development of alternative and underground financial systems, which are essentially "below the radar" of those properly concerned with the advancement of integrity and the protection of our societies.

# 6. LEGAL RISK AS PART OF OPERATIONAL RISK

Perhaps the greatest problem with the above-mentioned phenomenon of over-reaction or mis-reaction to threats is the impact that it has on the incidence of risk and on the management of legal risk in particular. Those involved in handling other people's wealth have in most jurisdictions for long been held to the standards of good stewardship. They are invariably cast in some sort of fiduciary relationship to those who have entrusted them to deal with their money or securities. While the terminology and the ability to secure effective remedies may vary considerably from one legal system to another, in most, there are certain basic obligations that are both common and commendable. It is also the case that in recent years, states have imposed, both directly and indirectly, on such persons an increasing burden of obligations that often go somewhat beyond the basic duties of stewardship. It is no exaggeration to say that in the United Kingdom, for example, the impact of anti-money laundering laws and procedures on the way that business is actually done in the financial system is probably as great, if not greater, than any other set of rules and regulations. Consequently, those who are engaged in the professional intermediation of wealth will expect to be bound by these obligations and

will be aware that adverse and occasionally serious consequences will flow from non-compliance. The focus has become, in many developed financial systems, the relationship between the regulator, charged with the supervision and administration of such laws, and the regulated industry. Whether this is desirable or not is beyond the scope of this chapter. However, the replacement - in practical terms by technical. compliance-based rules - of the traditional notions of good stewardship may not be in the interests of those ultimately paying for the service in question, whether as customer or as investor. The compliance industry tends to operate at the lowest common denominator and a box-ticking approach to issues of integrity, conflict, and fairness may not serve the long-term interests of the markets. Again, however, hard-pressed and often under-resourced regulators may find such points academic. That their own regulations and procedures may not comport, in every respect, with the underlying law appears to be an even less relevant point.

What is not always taken on board by the regulators, and those subject to them, is that the imposition of additional procedures – such as in the case of money laundering – can not only raise threats of legal exposure for non-compliance, primarily at the behest of the regulators or other law enforcement agencies, but also throw up other issues of legal liability.

Perhaps an example would be helpful in this context. In most common law systems there is a real prospect of civil liability in cases where a bank or other intermediary assists another in transferring or even retaining the proceeds of certain civil wrongs - such as frauds or breaches of trust. This liability is wholly independent of the specific provisions that may exist in the criminal and regulatory laws relating to handling or laundering the proceeds of a crime. It is also the case that a bank or other intermediary may find itself liable at civil law for receiving the proceeds of such a civil wrong. This is not the place to enter upon a detailed discussion of what is a controversial area of the law, and one that does to some extent vary from one jurisdiction to another. The important thing to note is that it is quite possible for a bank of other financial intermediary to discover that it is in possession of funds or has assisted in the "laundering" of such funds, quite innocently. In such circumstances, to avoid or at least mitigate its exposure to claims by those who may have a legitimate interest in the funds in question, it is appropriate for the bank or other fiduciary to seek out those who have such claims or at least seek the assistance of the courts. At the same time, if they do have knowledge of facts which give them grounds for suspicion that the funds may be the proceeds of an activity that could amount to a crime in their or another jurisdiction, there may be an obligation under the law to report that fact to the authorities. It will also often be a specific criminal and regulatory offence to disclose to any third party that an investigation by the authorities is imminent.

The problem for the bank - and its legal advisor - becomes apparent. In one relatively recent case, the Bank of Scotland found itself in a similar dilemma. As Lord Woolf, then the Lord Chief Justice, put it: "[T]he bank believed that it had a dilemma. If it paid out the moneys held in the account, it considered it could be held liable to third parties as a constructive trustee. If it did not pay out the moneys it held, an action could be brought and the bank would not be able to defend itself because the police objected to the bank revealing what they had told the bank ... " Lord Woolf accepted that "the bank was ... in a genuinely difficult situation. There was a dilemma as to what it should do."31 The Court of Appeal was prepared to make available its jurisdiction to provide declarations that would protect a bank from criminal proceedings, although it should be carefully noted that the judges thought that such declarations "will not automatically provide protection for a bank against actions by its customers or third parties. ... " Furthermore, Lord Woolf emphasized that the fact that the courts might be willing to make declarations "must not ... be regarded as a substitute for financial institutions taking the decisions which should be their commercial responsibility." In other words, the management of such risks is properly a managerial obligation of the bank. The new legal risks that are thrown up by these and other laws are not always fully appreciated. This is so a fortiori when we move into the area of Islamic finance, which is significantly more uncertain from a legal point of view.

### 7. ISLAMIC FINANCE AND LEGAL RISK

The wider issues of governance in financial and business structures that are in compliance with the Shari'ah are beyond the scope of this present chapter. What we seek to address here, in the context of Basel II, is the determination of legal risk within the context of accounting for operational risk. Unless such issues are addressed, then much of the structure for improved surveillance and indeed governance becomes little more than "window dressing" – at best. At worst, it becomes a trap for the unwary. At the outset, it has to be

recognized that there is considerable uncertainty as to what Basel II is intended to cover with respect to legal risk. Indeed, the General Counsel of the U.K.'s Financial Services Authority (FSA), Andrew Whittaker, observed in May 2003: "[T]here is, so far as I am aware, no authoritative guidance, from the Basel Committee or elsewhere, on the appropriate systems and control needed to manage legal aspects of operational risk."32 Speaking in the context of the management of legal risk by lawyers. Whittaker on another occasion stated: "IWIhen talking about legal risk, people mean different things. There is no standard definition of legal risk and it may not be very helpful to produce one,"33 In the context of Shari'ah-compliant institutions, it is at least arguable that the constraints within which the business will be operated are likely to produce better standards of governance than conventional business forms. Irrespective of the restriction of business activities to those that are halal, the Shari'ah Supervisory Board, while often having an unclear mandate in governance, might be expected to achieve certain limitations on otherwise unacceptable conduct on the part of those charged with management. However, there are other aspects to Islamic financial activity that might well be thought to raise specific issues of concern in governance. These are dealt with elsewhere in this book. However, it would be wrong not to highlight here the problems associated with relative lack of transparency and those that arise from the very nature of essentially commodity-based transactions. There are also issues of "off-book" activity and, in particular, the use of "special reserves" for (among other things) "smoothing" investment returns. Indeed, there are those who claim that these and other factors significantly increase the potential for conflicts of interest, insider abuse, and even money laundering. The reality is that there is little evidence to support such contentions. Perhaps of greater concern, particularly in the focused discussion in which we are engaged in the context of Basel II, is the legal problems that are associated with the provision of Shari'ahcompliant financial products and services and the implications that this has for the creation of a viable international Islamic financial system.

At the outset it has to be remembered that with the notable exception of the United States, very few jurisdictions have addressed, in any detailed and deliberative manner, the development of appropriate legal structures for creating, raising, and then trading financial instruments. The Americans did it in the 1930s in the context of their "New Deal" in an attempt to resurrect the financial markets after the

"Great Crash." In many respects their legislation was driven by the scandals and abuses that came to light during this turbulent period. Indeed, it has to be admitted, as we have already observed, that in many countries substantial reform only comes about as a consequence of a "crash" or series of major scandals. Cool and deliberative reform is a luxury that few have had. It is also the case that scandal-driven regulation inevitably tends to focus on issues of abuse and does not adequately address the issues that are more important for development and sustainability. Many Islamic states have a golden opportunity to construct sound legal regimes for financial systems that are compliant with Shari'ah in a deliberative and careful manner.

In this context, we acknowledge that the creation of financial institutions and financial products that are accepted as being in compliance with Islamic law are relatively recent developments. It must also be remembered that in the realm of our discussion, we are talking as much about culture as we are about legal tradition – or about law in the sense in which we would recognize it today. Indeed, some of the issues that remain problematic today in fashioning the rules for finance relate back to pre-Islamic values and practices.

For example, we sometimes forget that Islam is not alone in condemning the taking of riba. In the ancient world the taking of interest was considered usury and generally, albeit not universally, condemned as "eating" away the resources that should be utilized in repayment. While the Code of Hammurabi and even earlier Babylonian laws appear to sanction the taking of interest, commercial loans were not the practice in the ancient world. Lending was seen to be an act of charity and obviously would not sit well with taking of additional and unearned payment by way of interest. There are coffin texts in ancient Egypt that appear to condemn usury in this sense. The Old Testament has many such references. Those of us who follow, in one way or another, the legal traditions of Rome, would recognize laws of both the Republic and the Empire condemning the taking of excessive interest, although it would seem that loans were rarely advanced without the prospect of some reward, financial or political. Christianity has also been forceful in its condemnation of usury, or, in the early Church, of interest at all, save, as we have already mentioned, in the case of risky maritime ventures. Jesus, while endorsing the earning of income from investment (Matthew xxv.27 and Luke xix.23) condemned the taking of interest: "Give without hoping to make gain" (Luke vi.31). Indeed, Dante goes as far as to

place usurers in the third ditch of the seventh circle of Hell, alone with the blasphemers and sodomites!

Furthermore, it is not only the Islamic scholars who accepted the creation of finance through real commercial transactions with reward being found in the sharing of profit. The Medici used similar devices and, in particular, deployed staggered payment through timed bills issued in series; a practice that continues in some trades, in one form or another, to this very day. Where the laws of Islam part company with many of the other great legal traditions is that, given its founding on indisputable principles of a profound and theocratic nature, it has not willingly tolerated a dispute as to the difference between the mere taking of interest per se and the charging of excessive or abusive interest, with the condemnation of usury being focused on the latter. Thus, today in most secular legal systems, largely as a result of commercial and pragmatic factors, the taking of interest is accepted, but the demand for excessive interest is outlawed as usury. Unconscionable bargains will be struck down and rendered unenforceable.

While the inherent integrity of Islamic thinking must be applauded, it is increasingly being recognized that in certain contexts the Islamic law needs to be developed - albeit within the confines of Holy law. Indeed, the eminent Shari'ah lawyer and scholar, the late Dr. Zaki Badawi, observed that Shari'ah boards should "resurrect the tradition of imaginative solutions formulated and implemented by the Hanafi Scholars of the past."34 Indeed, he considered that such a dynamic approach might well result in certain derivative securities being considered acceptable. Indeed, there are even a few Islamic scholars who have contended that interest payable in ordinary banking transactions is outside the concept of riba, although it must be said that the vast majority of scholars would have serious objections to such a view. It is not without interest that in a leading case before the Court of Appeal in England, the scholars who were called as expert witnesses expressed the view that "whenever a question of interpretation of the principles contained in the Koran and Sunnah is involved, the application of the rules of the Shari'a has and will continue to give rise to disputes between different jurists."35

There is, in many parts of the world, a resurgence of interest in the study of Islamic law and legal traditions. However, it must also be recognized that in many places there is still ignorance, and from this ignorance springs suspicion and misunderstanding. Perhaps the most serious stumbling block to the effective and efficient development of

truly Islamic financial products and services is the uncertainty that pertains within the relevant legal systems and as to the impact of the law.

Despite this resurgence of interest in Shari'ah law and, in particular, the provision of financial and banking services that are compliant with the Holy Scriptures of Islam, it has to be admitted that there are few Islamic scholars in Western universities and even fewer trained in or knowledgeable of Islamic financial law as such. Indeed, even in Islamic countries it cannot be assumed that competent expertise particularly in regard to the application of Shari'ah to the financial sector is widely available. In fact, concern about the paucity of scholars and experts has led to the Malaysian government giving priority to the establishment of specialized educational programmes. Other countries have taken similar steps. The barriers to the acquisition of knowledge, let alone expertise, are not simply those of language and culture, albeit these are in themselves substantial and in many cases practically insurmountable. There is also the very complexity and diversity of opinion and learned interpretation within the schools of Islamic law. On important issues, again particularly in regard to financial law, there is real discussion and debate. The uncertainty of the law and, in particular, its application is, as we have pointed out, one of the most serious hurdles facing the development of Islamic finance. Take what is arguably the most fundamental issue in any legal system, that of constitutionality. Most Islamic states provide in their constitutions that Shari'ah is a source, or in some such as that of Egypt, the principal source of law. This means, at least in the latter case, that all other laws and decisions made in the relevant jurisdiction are subordinate and may be considered at some time in the future non-compliant with Shari'ah and therefore null and void. The legal certainty that has been recognized as a key characteristic of a modern legal infrastructure is still in the process of consensual development in Shari'ah jurisprudence. The resultant lack of legal certainty must be recognized as a problem in the context of our present discussion. For example, article 2 of the Constitution of Kuwait provides that Shari'ah is a principal source, albeit not the principal source, of law. The Constitution of Oman provides that Islam is the religion of the state and Shari'ah is the basis of all legislation. Whereas in Jordan, Islam is declared to be the religion of the state, the nation itself is the source of all powers under article 24 of the Constitution. Just imagine how difficult it is in practice to arrive at a view - across the region - as to how a

particular transaction, under different laws and subject to different interpretations of even the Shari'ah, might be enforced. Even on the issue of riba views may differ, as we have seen. But let us take another important legal concept – where there is probably rather more controversy within the schools – that of gharar. In the Qur'an and the Hadiths, this word is used on more than 50 occasions in very different contexts appearing to mean things as diverse as "danger" and "deception".

Much of the "nuts and bolts" of the legal architecture that we are discussing is to be found in so-called special laws specifically enacted. These do not always sit particularly well with even the wording of various constitutions, let alone the interpretation of Shari'ah. Dr. Lu'aay Al Rimawii, formally of the Universities of Cambridge and London, has written with authority on this issue in regard to the securities laws of Iordan. 36

In his view, these special laws, such as the Financial Market Law of 1976, sit uncomfortably with the strict limitations imposed by riba and gharar. A particular area of concern is the scope of the definition of securities. For example, section 3 of the new Securities Act of 2003 is, in his view, in certain respects excessively vague, thus introducing issues of uncertainty and risk. Professor Aishah Bidin, of the University of Malaysia, has made similar observations in her writings in the context of the relevant statutory provisions in Malaysia.37 Dr. Rimawii observes: "[A]s far as the Arab countries maintain this incongruous dichotomy between general principles of law enshrined in the Shari'a and particular secular laws, juridical risks will always jeopardise the certitude of modern commercial legislation," While Dr. Rimawii's comments are largely focused on the experience of Jordan, it is not difficult to find other examples in the region. For example, the Capital Market Law of 2003 in Saudi Arabia faces similar issues particularly in the context of securitization.

As we are aware, this risk is sadly not confined to the Middle East and the Arab world, as is indicated by the decision of the High Court of Pakistan in 1999 outlawing the charging of interest under certain legal provisions. There are, of course, more recent examples in both Malaysia and Indonesia, albeit in different areas of the law. The uncertainty in the "nuts and bolts" of the financial law was a factor in the decisions of the Court of Appeal in England in 2004 declining to allow Shari'ah law, in regard to murabahah, to modify the chosen law of contract.<sup>38</sup>

These uncertainties of law, at many levels within the legal system, are exacerbated by the failure of practitioners to address standardization of documentation in transactional situations, such as the murabahah in particular. While practitioners seek to justify this on the grounds of diversity of fact and environment, the failure to have standard documentation increases not only interpretational risk, but also transactional costs. It is also the case that the approach of Islamic law to the creation of rights and their synchronization tends to further complicate these processes.

### 8. A STRATEGY FOR THE FUTURE

At the heart of a strategy to achieve an enduring international Islamic financial system that is capable of providing those who wish to avail themselves of Islamic products and services – whether for religious or other reasons – is The Islamic Financial Services Industry Ten-Year Master Plan (2006–2015): A Framework, recently drafted by the Islamic Research and Training Institute of the Islamic Development Bank and the Islamic Financial Services Board. This important document makes it very clear that if markets of the depth and breadth that are required to accommodate the expectations of those who wish to use Islamic products are to become a reality, the number, strength, and capitalization of Islamic financial institutions and intermediaries will need to increase significantly. To achieve this, the availability of financial products that have the flexibility, liquidity, and security to service this demand is vital.

Perhaps the most significant element in the equation today, in this context, is the efficacy of sukuk (Islamic securities) in meeting the demands of not just the primary markets, but also developing secondary markets. While Islamic financial institutions, and conventional banks and institutions that offer Shari'ab-compliant products and services through their "Islamic windows," have achieved some success in the issues market, for the secure, stable, and efficient market that is required to sustain and develop Islamic finance, a viable and reliable secondary market operating at an international level is vitally important. Therefore, it is necessary for us to examine in a little more detail the problems that remain – primarily of a legal nature – in regard to this crucial vehicle. It is in regard to the issue, administration, and trading of these particular securities that there are real issues of legal risk.

First, let us raise a practical issue, that of the location of the special purposes vehicle (SPV), which is necessary for the effective creation and operation of this particular form of investment.

In contemplating suitable venues, discussion has tended to be dominated by considerations of tax and, in particular, exposure to the U.S. tax regime. While this is an issue of very real significance in wealth planning, we have to be aware that attitudes to the so-called tax havens have changed dramatically in recent years. The U.S. Department of Treasury has recently estimated that the U.S. government is losing well in excess of US\$32 billion a year in tax revenues by courtesy of the "havens." This situation is not going to be allowed to continue. By the same token, it is important to consider the service costs involved in certain locations and the fact that the risks of regulatory intervention, for a variety of reasons, have increased greatly in recent years. While the issues associated with financial and client privacy are not identical to those raised in the debate on tax sheltering and downright evasion, in the minds of many there is a clear relationship.

Although there was a debate in regard to how far planning and placement might be permitted in the wider public interests of enterprise, and until 9/11 the Bush Administration was by no means as "hawkish" as, for example, the European Union, following the declaration of the "War on Terror" the reality is that financial privacy is – at least in law – a dead issue. Furthermore, while issues in regard to insolvency are much wider than those pertaining directly to the SPV, it is exceedingly important to ensure that the chosen location has laws and, most importantly, a judicial system capable of adequate and competent administration, should insolvency become relevant. It cannot be assumed, for example, that the laws are necessarily similar – not least in their administration – even within reasonably close geographical regions such as the Caribbean, let alone the Pacific.

Given the significance in Islamic financial transactions of conveyances of property and, in particular, land and interests in realty, the diversity of attitudes exhibited in Islamic states to the rights – if any – of foreigners and the procedures for transference and holding, is a veritable minefield. In this respect, the domestic laws of many states that wish to facilitate the development of Islamic financial systems and products require attention. Until there can be an assurance that transfers of interests in land, in particular, are effective and will be

accepted by the courts, whether religious or lay, in the relevant jurisdictions, it is hardly surprising that those who advise major financial institutions, and especially the credit rating agencies, will be cautious.

We have already referred to the view that, given the transactionbased nature of financial instruments in Islamic finance, there may be more scope for concern as to issues of conflict of interest and self-dealing. In this context, it is important to note that the underlying law may not always be certain in even highly developed legal systems. Indeed, in England there is still uncertainty as to the extent to which the courts would permit the modification of the strict principles relating to the avoidance of conflicts of interest and, in particular, conflicts of duties. 39 The efficacy of "Chinese walls" in resolving real or potential conflicts and preventing the misuse of price-sensitive information is, as a legal issue, yet to be resolved even in the City of London. Mention has already been made of the tendency of financial supervisors and regulators to take rather pragmatic attitudes to such issues, which may in fact not comport with what the law actually provides. Chinese walls may effectively prevent the flow of information within an institution, but they do not resolve the inherent conflict of interest; indeed, they may in fact exacerbate it.

There is currently a major concern in the United Kingdom to ensure that financial institutions and intermediaries treat all their customers fairly. How such (often vague) standards would stand up to a legal challenge remains unclear. Indeed, there are those who have argued that a principles-based system of regulation may not endure a legal challenge based on issues of constitutionality, certainty, due process, and human rights. This has already been an issue in regard to enforcement, particularly in the area of the criminal law or where the administrative sanctions resemble criminal penalties. There are, for example, many situations, often in the realms of governance and integrity, where the impact of new and developing principles on existing business practice, and in particular the relationship with regulators, have not been fully worked out. It must not be forgotten that the impact of laws and regulations on, for example, money laundering, on how business is actually done in the West is in many ways more significant than that of laws specifically enacted to regulate investment transactions and their legal environment. The impact of laws creating collateral obligations and risk should never be underestimated.

Perhaps one example will suffice. In many Islamic states the danger of insider dealing has long been recognized. Indeed, one of us had the honor of writing a book on this topic in 1979. While specific provisions in the law were then relatively rare, the dangers of insider abuse were addressed in provisions, such as that of article 72 of the then Saudi law – Decree No. M6 (July 20, 1965) – imposing what might be described as "fiduciary" obligations on directors and other insiders. Since then, many states have enacted specific legislation, much in the same way as with money laundering. What has not really been given a great deal of thought is the implications for the grafting of these essentially Western legal concepts on to essentially traditional business models. For instance, decisions of a Shari'ah council or advice from a scholar on a particular transaction might well amount to inside information. The implications of this have not really been considered. Indeed, the problem has only recently manifested itself in a matter in Malaysia.

If sukuk are going to become the vehicle that so many assume, it will be desirable to expand the scope of obligations that can be brought within it. To depend on the ijarah sukuk places considerable practical difficulties in the way of the development of the sort of market contemplated in the Ten-Year Plan, Indeed, we have already referred to the problems that exist in many jurisdictions in regard to property law and the creation of transferable interests. Another serious practical issue is the reluctance of credit-rating agencies to rate Islamic financial products satisfactorily. This is a major stumbling block to the development of viable secondary markets. As far as the leading international credit-rating agencies are concerned, there has been considerable caution as a result of the perceived and no doubt actual uncertainties in the law and its application. In particular, there is real uncertainty in many Shari'ah-compliant transactions providing a vehicle for finance, as to whether effective resort can be had to the underlying security or collateral.

In what have been called pure Shari'ah jurisdictions, such as Iran and the Sudan, there is a perception in some quarters that the courts are relatively unpredictable in their handling of financial legal issues and the lack of precedent, in the conventional sense of the word, exacerbates investor and professional advisors' sense of unease. The degree of discretion in the process of determination within Islamic courts, as compared with secular courts, is a matter for debate. Courts vary from one jurisdiction to another and even within jurisdictions. While it may be true that in practice there is little difference in the way tribunals, whether seeking to apply the principles of Islamic law or wholly secular law, actually function, the perception is that

Islamic courts are more likely to express themselves in discretionary terms. It is also the case that the process of adaptive and applicable reasoning from the principal tenets of Islam is a broader approach than the interpretative processes found in secular systems. It must also be acknowledged that in many Islamic jurisdictions there is not the range or depth of, in particular, interim and pre-trial measures. This is a particular issue in instances of insolvency. There are also those who express concern as to the adequacy of financial remedies before certain courts. Those who have attempted litigation in some jurisdictions will have some sympathy with this concern.

There are other issues that are of practical significance and worry the rating agencies. For example, it is uncertain whether under Shari'ah law an agreement not to petition for a winding up, or some equivalent procedure, would be enforceable. Indeed, it is unclear as to whether even an agreement for only limited recourse would be recognized and given effect. It is questionable whether under Shari'ah law it is possible to waive a right before it accrues. The schools take different views on this issue. The rights, if any, of bona fide purchasers and other third parties who act in good faith in relation to property that may be subjected to a legal claim remain obscure.

We have already emphasized that it is important to appreciate that in legal systems which are not wholly Islamic with a unitary source of law, Shari'ah law will have to operate to a greater or lesser extent alongside other laws. A good illustration of this is the recent case of Ryad Bank v. Abli United Bank (UK) Plc,42 in which a duty of care arose between the parties and had implications for the business relationship of two institutions that were engaged in providing Shari'ah-compliant financial products and services. Shari'ah courts also vary in their attitude to the decisions of other tribunals. There is a problem in being at all certain as to the effect and enforceability of foreign court judgments and, in particular, arbitration awards. This is a real issue for the rating agencies and those responsible for the management of legal risk. It is also the case that Shari'ah scholars may also need to become more conversant with financial and banking practices. While we in no way suggest that principles should be bent to accommodate expediency, there are situations where failure to truly appreciate the nature of a transaction may result in a misapplication of principle and learning. This is a problem that is not confined to Islamic jurists. Indeed, many jurisdictions have recognized the need for specialized courts and judges to deal with these areas.

The determination of risk, which is at the heart of any effective system of governance, is, thus, in the context of Islamic finance, fraught with problems. Here we have addressed some of the purely legal issues. There are many others that to a greater or lesser extent, depending upon the jurisdictions in question, will be pertinent. Until there is a greater degree of certainty in this area, the assessment of threats and the impact of risks that occur, whether from the point of view of those charged with management, governance, or supervision, is going to be a distinctly inexact science. Whether this will lead to further stability and promote the development of effective Islamic financial markets is questionable. Increased discussion and collaboration between academic institutions is to be welcomed, as is the all-important work of bodies such as the Islamic Financial Services Board, in bringing more deliberated certainty to this most important sector of the world's economy.

### **ENDNOTES**

- Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," updated November 2005, para. 1.
- 2 Ibid., para. 11.
- <sup>3</sup> Andrew K. Muleki, "Comments on Principles of Basel II," Governor of the Central Bank of Kenya addressing the Symposium of the Association of African Central Banks on Risk Based Supervision and the Implications of Basel II, Accra, Ghana, July 28, 2005, paras 12–13; and Dallas McGillivray, "Beneath the Surface Calm," Funds Europe, May 2005, p. 68.
- Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," updated November 2005, para. 721.
- 5 Ibid., para. 722.
- <sup>6</sup> Kern Alexander, Corporate Governance and Banking Regulation, Working Paper 17, Cambridge Endowment for Research in Finance, June 2004, p. 11.
- Andrew K. Muleki, "Comments on Principles of Basel II," Governor of the Central Bank of Kenya addressing the Symposium of the Association of African Central Banks on Risk Based Supervision and the Implications of Basel II, Accra, Ghana, July 28, 2005, para. 14.
- Financial Guardian Group, "The Risk of Operational Risk-based Capital: Why Cost and Competitive Implications Make Basel II's Requirement III-advised in the United States," February 2005, p. 35.
- <sup>9</sup> It is to be noted that recognizing that different governance structures exist world-wide, the Committee refers to "the board of directors and senior management," to "label the management and oversight functions within a bank," and not for the purpose of identifying "legal constructs" see Basel Committee on Banking Supervision, "Enhancing Corporate Governance for Banking Organisations,"

- February 2006, para. 7; and Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," updated November 2005, Part 3, II, 1, n. 117.
- Basel Committee on Banking Supervision, "Enhancing Corporate Governance for Banking Organisations," February 2006, para. 8.
- Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," updated November 2005, Part 3, IL.
- 12 Ibid., para. 727.
- <sup>13</sup> Basel Committee on Banking Supervision, "Enhancing Corporate Governance for Banking Organisations," February 2006, para, 60.
- <sup>14</sup> Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," updated November 2005, para. 729.
- Basel Committee on Banking Supervision, "Enhancing Corporate Governance for Banking Organisations," February 2006, Principle 2.
- 16 Ibid., Principle 1.
- <sup>17</sup> Testimony of D. Wilson Ervin, Hearings on Capital Reforms, Senate Committee on Banking, Housing and Urban Affairs, June 18, 2003, p. 4.
- <sup>18</sup> Robert Bailey, "Basel II and Developing Countries: Understanding the Implications," Working Paper 05–71, London School of Economics and Political Science, December 2005, p. 24.
- <sup>19</sup> See John C. Pattison, "International Financial Cooperation and the Number of Adherents: The Basel Committee and Capital Regulation," April 8, 2006, p. 22, expecting a similar level of adherence – over 100 adherents – to that of Basel 1.
- Principle 3 of the supervisory review see Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," updated November 2005.
- 21 Principle 4 of the supervisory review see supra, n. 20.
- <sup>22</sup> Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," updated November 2005, para. 759.
- 23 Ibid., para. 760.
- <sup>24</sup> See, for example, supra, nn. 10 and 13.
- Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," updated November 2005, para. 732.
- 26 Ibid., para. 644.
- 27 Ibid., n. 97.
- 28 See, for example, Lon Fuller, The Morality of Law, Yale University Press, 1964.
- <sup>29</sup> See also the discussions of "pure," "perfect," and "imperfect" procedural justice in J. Rawls, A Theory of Justice, Harvard University Press, Cambridge, Massachusetts, 1971.
- 30 See, generally, B. Rider and H. Leigh Ffrench, The Regulation of Insider Trading, Macmillan, 1979, Chapter 1.
- 31 Governor and Company of the Bank of Scotland v. A. Ltd. [2001] 2 All ER 58 at 71–73.
- "Legal Risks and the Basle Capital Accord," speech, FSA, May 22, 2003.

- 33 Journal of International Banking and Financial Law, Butterworths, January 2003, p. 5.
- <sup>34</sup> See Mushtak Parker, "Islamic Banking Product Diversity," Accounting and Business, June 2005, p. 42.
- 35 Statement of J. Khan, former Chairman of the Shari'a Appellate Bench of the Supreme Court of Pakistan in Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd. [2004] 4 All ER 1072 at 1082.
- 36 "Legal Aspects of Arab Securities Regulation, with particular reference to disclosure as a tool of investor protection when offering/listing shares in Jordan," Ph.D. Dissertation, London School of Economics and Political Science, University of London, July 2004.
- 37 "Corporate Debt Security A Comparative Analysis of the Protection of Creditors' Interests in English and Malaysian Law," Institute of Advanced Legal Studies, University of London, 2005.
- 38 Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd. [2004] 4 All ER 1072.
- <sup>20</sup> See, generally, Chizu Nakajima, Conflicts of Interest and Duty, Kluwer Law International, 1999; and Chizu Nakajima and Elizabeth Sheffield, Conflicts of Interest and Chinese Walls, Butterworths, 2002.
- 40 See B. Rider and H. Leigh Ffrench, The Regulation of Insider Trading, Macmillan, 1979.
- <sup>41</sup> See, generally, Barry Rider and Michael Ashe, Insider Crime, Jordans, 1993; and Barry Rider, Kern Alexander, and Lisa Linklater, Market Abuse and Insider Dealing, Butterworths, 2002.
- 42 (2006) EWCA, Civ. 780.
- 43 See Faisal M. Atbani, "Preventing and Controlling Financial Risks in Islamic Financial Institutions," M. Phil Dissertation, University of Wales, 2002.

# Transparency and Market Discipline: Basel Pillar 3

Daud Abdullah (David Vicary)

### 1. INTRODUCTION

I t is the view of this writer that good standards of transparency and market discipline are closely interlinked with good standards of corporate governance. As you will have read in previous chapters of this book, there are many areas of similarity, with regard to corporate governance, between conventional and Islamic financial institutions. You will also have read that there are some specific corporate governance issues that pertain only to Islamic banks. I do not intend to revisit the subject of corporate governance in any great detail during this chapter, merely to stress the importance of building a firm base of governance in order to help achieve good levels of transparency and market discipline.

It would be as well, in the context of this chapter, to give some insight as to the guiding principles of market discipline. Probably there is no better source than the Basel Committee themselves, who opine that

The purpose of Pillar 3 – Market discipline is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. The Committee believes that such exposures have particular relevance under the Framework, where reliance on internal methodologies gives banks more discretion in assessing capital requirements.

In principle, banks' disclosures should be consistent with how senior management and the board of directors assesses and manages the risks of the bank. Under Pillar 1, banks use specified approaches/methodologies for measuring the various risks they face and the resulting capital requirements. The Committee believes that providing disclosures that are based on this common framework is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and understandable disclosure framework that enhances comparability.

In a nutshell, then, the purpose of Pillar 3 is to focus on two key areas: first, to re-enforce market discipline through enhanced disclosure, which includes capital adequacy calculation; and second, to instill market discipline to re-enforce minimum capital requirements, to impose incentives for banks to behave prudently, and to promote safety and soundness in banks and financial systems. Under no circumstances should Pillar 3 be seen as a way to get the market to do the supervisor's job or, indeed, to get the market to police the supervisors. Let me leave that thought with you there and I shall return to it later in this chapter.

## 2. COMPLIANCE WITH PILLAR 3

What, then, is required of banks in order to comply with the requirements of Pillar 3? The requirements may be summarized under the following headings:

- · Level of disclosure
- · Frequency of disclosures
- · Disclosure templates
- Basic principle of disclosure.

## Level of disclosure

With regard to the level of disclosure, it is mandatory for all banks to disclose at the standard or basic level. Additional mandatory disclosures will be required for those banks taking advanced approaches.

## Frequency

Disclosure should be made every six months via sources that are set by the respective national supervisors. Qualitative disclosures should be made annually. In situations where information on risk exposure is prone to rapid change, disclosure should be made on a quarterly basis. All information provided is subject to verification.

## Templates

Templates have been suggested as a means to ensure comparability between banks.

## Basic principle

Disclosures should be consistent with how senior management and the board of directors assess and manage risks.

Thirteen tables are prescribed in Pillar 3 relating to market discipline and the respective aspects of qualitative and quantitative exposures for each table:

- Scope of application; Gives details on the qualitative and quantitative disclosures required. This allows the market to assess how Basel II applies to a banking group and how the various entities within the group are treated for capital adequacy purposes.
- 2. Capital structure: Summary information on the terms and conditions of the main features of all capital instruments. Disclosure about the amount, components, and features of capital provides market participants with important information about a bank's ability to absorb financial losses. Information on the terms and conditions of capital instruments provides additional background on the loss-absorbing capacity of capital instruments and provides a context for the analysis of the capital adequacy of the bank.
- 3. Capital adequacy: A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities. Capital requirements for credit risk, equity exposures in the internal ratings-based (IRB) approach, market risk, operational risk, and the total and Tier 1 capital ratio. In order to provide market participants with a link between the disclosure of capital and risk exposure and assessment, it is important that a bank publishes

information about its capital adequacy based on Basel II. Under Pillar 2 it is recommended that all banks have an internal process for assessing their capital adequacy and for setting appropriate levels of capital. This process should be objective and overseen by senior management, and all banks should be able to demonstrate that the results of their internal processes are credible and reliable. Information provided about a bank's capital allocation process assists market participants in gaining a better understanding of the risks and rewards inherent in the bank's activities.

- 4. Credit risk: General disclosures for all banks from both a qualitative and quantitative perspective. This section sets out general credit risk exposures for all banks, regardless of which regulatory capital assessment technique they use. The aim is to give an overview of the size and nature of the bank's credit risk exposure and to provide the context for information on how a bank assesses and manages that risk.
- 5. Credit risk: Disclosures for portfolios subject to the standardized approach and supervisory risk weights in the IRB approaches. This allows the market to assess asset quality by providing a breakdown of the bank's exposures in the standardized framework. Furthermore, this provides market participants with a sense of the suitability of the standardized approach for the particular institution (that is, that the resulting weights for capital purposes properly reflect the exposure of the underlying asset) and provides a basis for comparative analysis of banks.
- 6. Credit risk: Disclosures for portfolios subject to IRB approaches. This disclosure regime is intended to enable market participants to assess the credit risk exposure of IRB banks and the overall application and suitability of the IRB framework, without revealing proprietary information or duplicating the role of the supervisor in validating the detail of the IRB framework in place.
- 7. Credit risk mitigation: Disclosures for standardized and IRB approaches. Basel II recognizes an enlarged range of credit risk mitigation techniques for regulatory capital purposes. The disclosure regime is intended to allow market participants to assess the types of mitigation employed and their impact on risk and regulatory capital levels.

- 8. Securitization: Disclosure for standardized and IRB approaches. In order to gain preferential capital treatment with respect to asset securitization, a bank must disclose information about the size, type, and features of securitizations to allow market participants to assess the resulting impact on the bank's risk profile.
- Market risk: Disclosures for banks using the standardized approach. The disclosure regime for the standardized approach is based on the capital charge as a proxy for the risk indicator, allowing a comparison between different types of risks and between different institutions.
- 10. Market risk: Disclosures for banks using the internal models approach (IMA) for trading portfolios. The disclosure regime for the IMA is based on the value-at-risk (VAR) concept, the common metric in internal market risk models. Market participants can judge the exposure to market risk and verify the results of the model, in broad terms, compared to the actual outcomes. The qualitative disclosure of portfolios covered by the IMA allows market participants to evaluate the sophistication of the bank's risk measurement and management based on the qualifying criteria for the IMA.
- 11. Operational risk: This is an important feature of Basel II. The metric to assess exposure, across all capital calculation types, is the capital charge itself. The disclosure of the regulatory capital approach that a bank qualifies for basic indicator, standardized, or advanced measurement approach provides useful information to market participants about the quality of risk identification, measurement, monitoring, and control as incremental standards apply to each of the three capital assessment techniques.
- Equities: Disclosures for banking book positions. Note that
  for Islamic banks, equity positions in the banking book
  include assets resulting from financings made by the bank
  based on musharakah or mudarabah contracts.
- 13. Interest rate risk in the banking book (IRRBB): Interest rate risk in the banking book does not attract a minimum regulatory capital charge in Pillar 1, but is rather dealt with under Pillar 2 the supervisory review process. This places considerable importance on the disclosure of comparable

information by banks to allow market participants to assess the current and potential level of interest rate risk in the banking book, the means by which the bank identifies, measures, monitors, and controls the risk, and the results of this process. For Islamic banks, there is no IRRBB as such, but there is rate of return risk which is a major factor in displaced commercial risk (see, for example, Sundararajan, 2006, Chapter 3 of this volume). Rate of return risk, insofar as it contributes to displaced commercial risk, is therefore dealt with under the Islamic Financial Services Board's (IFSB's) Capital Adequacy Standard (Pillar 1).

While there may be a need to change some of the details in Pillar 3 to adapt to the requirements of Islamic banks, the general direction and relevance of these essential elements of market discipline cannot be denied. They will therefore be generally applicable to the world of Islamic finance. However, like everything else, there are potential benefits and drawbacks to their implementation. In particular, I would draw your attention to the need for a sense of balance between the regulators and the market.

# 3. MARKET DISCIPLINE IN ISLAMIC BANKING

"Market discipline" refers to the use of the market as a means of governance, as a complement to regulation and supervision. The potential benefits and drawbacks of this approach are set out in Exhibit 19.1.

I would also like to reiterate some thoughts developed by Andrew Crocket, former Bank for International Settlements general manager, on the conditions necessary for effective market discipline (see Exhibit 19.2). These thoughts are equally applicable to the world of Islamic banking. First, information: market participants must have sufficient information to reach informed judgments. Second, ability: market participants must have the ability to process information correctly. Third, incentive: market participants must have the right incentive to act upon information. Fourth, mechanism: market participants must have the right mechanism to exercise discipline. All four prerequisites will need to be developed in order to achieve effectiveness. However, the focus, at this point in time, should be on the first two conditions, without which we cannot move on to satisfy

EXNIBIT 19.1 Potential benefits and drawbacks of market discipline in Islamic banking

### Potential benefits

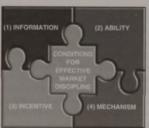
#### Potential drawbacks

- It can provide Islamic financial institotions with the necessary incentive to properly address relevant corporate governance issues and behave responsibly.
- Market reactions to early signs of distress in individual institutions provide impetus for the institution to rectify problems, hence preventing possible bank failures.
- Lower risk premiums in the marketplace resulting from transparency of operations which is a prerequisite for effective market discipline.
- Potential time and cost savings for regulators
- There may be a conflict of interest between regulators and the market (issue of public versus private interest). For example, markets may react too strongly on institutions in a weakened position, resulting in unnecessary failures, which regulators would prefer to avoid in order to maintain the soundness and stability of the financial sector.
- Loss of confidence in one bank may cause a "contagion" effect resulting in a systemic event occurring in the banking sector.

EXHIBIT 19.2 Developing market discipline in Islamic banking

Market participants must have sufficient information to reach informed judgments

> Market participants must have the right incentive to act upon information



Source: Crockett, former BIS General

Market participants must have the ability to process information correctly

Market participants must have the right mechanism to exercise discipline

conditions three and four. Let me elaborate a little on conditions one and two.

All four prerequisites need to be developed, which remains a major task for all. However, at this point in time, we believe the focus should be on building blocks (1) and (2), without which we cannot move on to satisfy conditions (3) and (4).

- Market participants need to have sufficient information to reach informed judgments:
  - a. There is a pressing need to develop the informational infrastructure of the industry in order to promote transparency to enhance the understanding of the operations of Islamic financial institutions.
  - Transparency facilitates decision making and hence improves the allocation of resources, as it enables us to better understand the intrinsic value of a financial institution.
- Market participants need to possess the ability to process the information correctly:
  - a. There is a need to grow the Islamic finance industry, as critical mass is necessary to attract capable market participants, such as analysts, brokers, ratings agencies, and institutional investors, with the ability to process correctly the information provided by the Islamic financial institutions. At this point in time very few Islamic banks are rated. It is to be hoped that as the market gains critical mass the value of obtaining an independent rating will also grow.
  - b. Thus it may, therefore, be easier to develop market discipline in countries with significant Islamic banking market penetration, including Saudi Arabia (20%), Kuwait (16%), Qatar (13%), Malaysia (12%), Bahrain (10%), and the United Arab Emirates (7%).

Earlier in this chapter I indicated that I would return to discuss further the purpose of Pillar 3. You will recall that I highlighted that the purpose was NOT to get the market to do the supervisors' job and NOT to get the market to police the supervisors. At this juncture I should like to introduce the concept of a "Virtuous Cycle of Transparency." This is a cycle that embraces all aspects of regulation, disclosure, transparency, corporate governance, market discipline, and the growth of the Islamic banking industry. Exhibit 19.3 illustrates the cycle.

Let me first examine the role of regulators in this context (see Exhibit 19.4). Initially, standards need to be set. Here we already have Pillar 3 and there will follow an Islamic equivalent, developed by the IFSB, which will follow the spirit of Pillar 3. The standards

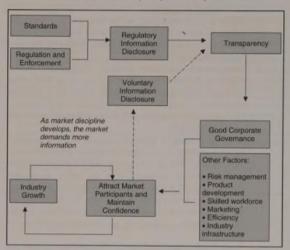


EXHIBIT 19.3 Transparency: A virtuous cycle

will need to be adopted by the local regulators on a country-bycountry basis (central bank or equivalent). In this role of standards
setting, the regulator(s) set the wheels of market discipline in motion
by developing coherent regulatory disclosure requirements which the
markets would find useful, both on a national and international
basis. Enforcement would most likely come at the country level,
whereby the central bank would enforce regulations by monitoring
the implementation and compliance of Islamic financial institutions to
the disclosure requirements. The regulator also needs to demonstrate
vigilance; in particular, there is a need to be vigilant about negative
signals sent by the market, as this may be an early warning of distress
in individual institutions. Timely involvement by regulators may help
to prevent or minimize the occurrence of bank failures.

Let me now examine what constitutes good information disclosure and lends itself to enhancing transparency in the marketplace. The board of directors and senior management of Islamic financial institutions must be committed to providing good information disclosure,

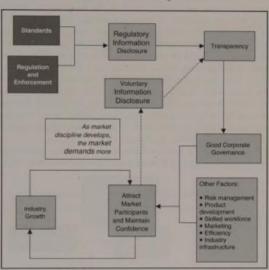


EXHIBIT 19.4 The role of regulators

both quantitative and qualitative, which meets the criteria of useful, accurate, complete, and credible.

Under the heading of *Useful*, the information required depends on what the market discipline is aiming to achieve. For example, if the objective were to demonstrate to the market that the bank is performing satisfactorily with adequate profitability, then financial statements and comparative analysis would be useful information. If the objective is to demonstrate good risk management, then information on how the bank is managing its risk exposures is pertinent. If the objective were to demonstrate *Shari'ah* compliance, then *Shari'ah* certification in the annual report and accounts as well as a description of the *Shari'ah* review program would be of great assistance. If the objective were to demonstrate a resolution of the conflict regarding investment account holders (IAHs) resulting from the dual fiduciary role of the bank, then information pertaining to both the asset allocation and profit allocation of the bank would be extremely useful.

Under the headings of Accurate, Complete, and Credible, it is necessary that the information is all of the foregoing so that the market may be confident in using the information. This may be achieved by means of using external parties – for example, auditors and ratings agencies – to verify the information provided. In addition, the information should be material; provided on a timely basis, and be easily available to the public. Here the use of the Internet, by using the bank's website, is of great importance. Furthermore, the provision of the information should not be unreasonably burdensome to the bank, especially the smaller ones. Finally, the information disclosed should not be, as far as possible, proprietary, which would endanger the competitive position of the bank. In this respect, adequate generic information should suffice (see Exhibit 19.5).

Let us now take a look at the role of the market participants in this "Virtuous Cycle of Transparency" (see Exhibit 19.6). Here I

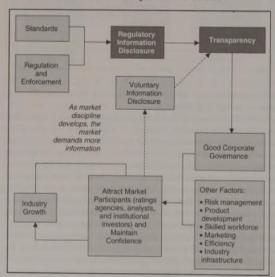


EXHIBIT 19.5 Criteria for good information disclosure

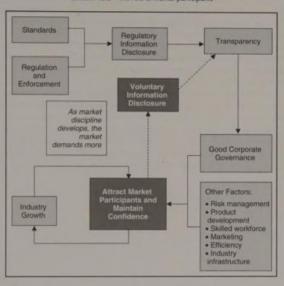


EXHIBIT 19.6 The role of market participants

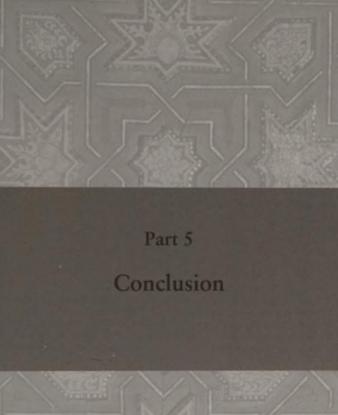
see two main roles. First, there is the role of disciplining institutions, where each market develops a reputation for rewarding and punishing institutions based on information disclosed to provide an incentive for good behavior. Reward good institutions by giving them good ratings and placing funds with them, and punish deviant institutions by doing exactly the opposite.

Second, there is the role of soliciting information, whereby the market relays the information needs to the financial institutions. Over time, as market discipline develops, the potential for voluntary information disclosure, based on market demand, also increases.

#### 4. CONCLUDING REMARKS

The Islamic finance industry has already demonstrated that it has the products and infrastructure to compete with conventional financial institutions. Annual growth rates are significant; in many markets, they are far outstripping the growth of conventional banking. However, the growth of the Islamic finance industry may be hampered if standard setters and regulators do not grasp the opportunity to move the industry forward by working together to develop a strong and practical corporate governance framework, incorporating elements of global best practice. To date, the signs that the industry can do this are encouraging.

As discussed previously, a good corporate governance framework will promote transparency via information disclosure by institutions that must be credible. This will help to inspire confidence in the marketplace and promote market discipline within the industry and ultimately serve as a catalyst to grow the industry and take it to the next level in the mainstream. Long journeys start with small steps, and we do not have a moment to lose!





## Human Resource Management of Islamic Banks: Responses to Conceptual and Technical Challenges

Volker Nienhaus

#### 1. INTRODUCTION

The Islamic finance sector continues to grow rapidly. Initially, the growth was driven by increasing transaction volumes of a limited number of Islamic banks. Later the number of Islamic financial institutions and the total customer base increased considerably, and the last decade saw the establishment of Islamic windows and subsidiaries of conventional banks as well as the introduction of Islamic products for individual and institutional clients. The continuing growth and the intensified competition among Islamic banks and between Islamic banks and Islamic windows and products of conventional banks imply quantitative and qualitative human resource problems for Islamic banks: they need more and better-qualified personnel, which still is in short supply.

Given the competitive situation, the high growth rates of past years, and the specifics of Islamic finance, the human capital requirements are particularly high – in product development and product placement (in retail as well as wholesale banking) and in risk management. Islamic banks' personnel must be familiar with conventional banking products and their status in relation to Islamic requirements, as well as with existing Islamic alternatives and their commercial advantages and disadvantages compared to the conventional products. Staff

members must be able to explain to customers why specific products are not available and what the Islamic alternatives are. Furthermore, the management of Islamic financial institutions must be able to design Shari'ah-compliant financial innovations in order to meet the diversified needs of the clients and to match the ever-increasing scope of conventional techniques, procedures, and products.

# 2. RECRUITMENT, RETENTION, AND QUALIFICATION OF PERSONNEL

The human resource literature usually deals with the recruitment, retention, and retirement of "human capital." Since retirement issues are not yet of major concern for Islamic banks, this topic will be ignored in the following. With respect to recruitment and retention, the following takes up topics of the conventional literature and relates them to the specifics of Islamic banking.

## 2.1. Broadening the Recruitment Base

Islamic banks in total can recruit personnel basically from two different groups of potential employees: first, from people seeking first-time employment; and second, from people already employed in the conventional banking sector. None of these people can generally be expected to have in-depth knowledge of Islamic finance. However, the Islamic financial sector has attracted the attention of students and practitioners who are willing to learn about its specifics – on a basic or more advanced level, and with a theoretical or practical orientation. This is substantiated by the growing number of higher education and training institutions offering an increasingly broader spectrum of study programs and training courses:

Several universities in Western and in Muslim countries allow
for a specialization in Islamic finance within their general graduate or postgraduate programs in accounting, banking, and
finance (for example, the University of London, Monash University Malaysia, and Webster University in the U.S.) or have
integrated the Islamic perspective into their general business
administration and finance programs (for example, the International Islamic Universities in Malaysia and Pakistan). It is
noteworthy that the only explicit Masters programme in Islamic
finance at a Western university (University of Loughborough, in

the U.K.) has been transformed into an M.A. degree in Islamic banking, finance, and management of the Markfield Institute of Higher Education which was established by the Islamic Foundation. Its academic degree programs are validated by the University of Loughborough.

- Comprehensive programs especially for banking, finance, insurance, and accounting professionals are offered by several institutions such as the Institute of Islamic Banking and Insurance in London (IIBI Diploma Course) or the Bahrain Institute of Banking and Finance (Advanced Islamic Banking Diploma). A unique venture is constituted by the Web-based postgraduate diploma programme in Islamic finance and management and the certification programs (Certified Islamic Banker, Certified Islamic Insurance Professional, Certified Islamic Investment Analyst) of the International Institute of Islamic Business and Finance (IIIBF) at Netversity.org, and the Certified Islamic Finance Professional at the International Centre for Education in Islamic Finance (INCEIF) in Malaysia.
- Shorter training courses for professionals on specific topics are
  offered by the previously mentioned institutions, as well as by
  an increasing number of commercial companies such as Islamic
  Finance Training (Kuala Lumpur) or Euromoney Training U.K.
  & Ireland.
- Finally, the number of one- or two-day seminars, conferences, and workshops on specific subjects such as sukuk, house financing, or risk management in an Islamic perspective is mushrooming in financial centers of the Muslim world as well as in Western cities.

Given the recent response of the education and training industry to the growing manpower needs of Islamic financial service providers, it seems that the number of recruitment candidates with a basic and even more specific understanding of Islamic finance is increasing and will continue to do so in the foreseeable future.

Although a general qualification of employees in Islamic finance is useful, it is not sufficient for Islamic banks in a competitive environment. Their success will not depend mainly on standardized products available from many providers, but on their own specific products. To familiarize employees with the distinct features of such products remains a prominent task of in-house training departments of each Islamic bank. The growth of external training facilities allows

a concentration of limited training capacities of an Islamic bank on its specifics. In-house training programs also offer good opportunities to familiarize employees with the mission, vision, and values of the institution in order to strengthen their motivation and engagement. Unfortunately, empirical studies on the internal human resource development strategies of Islamic banks are still lacking.

## 2.2. Payment and Benefits

A competitive base salary has to be offered for the attraction of new employees. Competition may force Islamic banks - at least in the medium to long term - to offer higher salaries for many positions than conventional banks. This is the case for employees who must be familiar with both the basics and techniques of conventional banks as well as of Islamic banks. In this sense, Islamic banks require a higher level of qualification of their employees, and candidates with such qualifications may still be relatively short in supply. This should be reflected in the base salary - at least if it cannot be taken for granted that employees accept a pay somewhat below their market value because they attach a positive value to the employment in an Islamic bank. Further, it is costly to replace qualified personnel. Cost factors are not only expenses for new recruitment and training, but in particular the opportunity costs associated with the loss of the specific expertise of a leaving person. Especially in the case of middle and top managers, these opportunity costs can be considerable. The problem is aggravated further if the leaving person is a bearer of "trade secrets." Thus, in general, it makes sense to make efforts to keep qualified personnel, and retention is one of the major dimensions of human capital management.

A competitive base pay is not only important for the first-time recruitment of employees but also for retention efforts. However, Islamic banks will hardly be able to retain their most qualified employees and managers if they cannot offer, in addition to the fixed salaries, attractive performance-related rewards. A vast number of different premium and incentive schemes has been designed in various sectors of the economy, including the finance sector. Such schemes, however, are not readily applicable in Islamic institutions because of Shari'ab or market limitations:

 Many schemes are suitable only for people whose contribution to a company's commercial success can easily be measured and where benefits can be linked to their efforts (for example, for salespersons or traders). The Islamic question here is whether Shari'ab limitations exist with respect to employment contracts when the salary of the employee is not fixed in advance but composed of a smaller fixed amount and a larger performance-related premium. This may contradict principles of traditional Islamic labour law.

• A more generally applicable scheme for performance-related rewards is based on stock options. This scheme has become most popular for top managers and chief executives. It is doubtful, however, whether this instrument can be applied in the Islamic financial services industry. The problem is not so much potential issues of the Shari'ah compliance of such schemes, but especially the fact that the stocks of many Islamic banks are not publicly traded. If stocks are held privately, and if secondary markets are virtually non-existent, the otherwise very effective instrument of stock options cannot be applied in the Islamic financial services industry.

Without empirical research it is impossible to say how relevant the issue of staff fluctuation and retention in the Islamic financial sector really is and what kind of performance-related rewards are granted. It would be very illuminating to know how many people have left Islamic financial institutions to take up new jobs either in other Islamic, or in conventional financial institutions of in institutions of the non-financial sector (with or without a relation to Islam). Such figures could give an indication, for example, of the strength of the "Islamic commitment" of personnel and could shed some light on the importance of ideological factors for the human capital management of Islamic financial institutions.

The base salary is usually supplemented by other benefits for employees, including, for example, health-care contributions, housing support, and retirement schemes. Islamic banks could also offer such benefits in principle, but the specifics of an Islamically legitimate health insurance or pension plan (for example, as provided by family takaful products) may be more complex and more difficult to explain to and be appreciated by the beneficiaries than conventional packages.

## 2.3. Work Environment and Motivation

Job satisfaction is a precondition for a continuous and long-term employment in a company. It is the result of a complex bundle of conditions, actions, and circumstances. Islamic financial services are "ideological" products. Those involved in the production and marketing of these products should have a common and consistent understanding of the Islamic content and of its relevance. An explicit mission statement will help to clarify the main issues, to homogenize attitudes, and to motivate the personnel. For many people, "Islamic" finance implies more than just legally interest-free contracts, and therefore an Islamic financial institution should support some "Islamic" activities outside its core business (for example, charitable events, scholarship programs, health-care programs for the poor, Islamic art exhibitions, and so on).

A strong commitment of employees to their company will most certainly reduce fluctuations of staff, enhance the productivity of the human capital, and improve the economic performance.

Identification with the institution's larger goals: It is a plausible assumption that identification with the institution's larger goals is more the case in Islamic financial institutions than in conventional ones. The reverse side of this coin is a larger potential for disappointment and frustration of personnel. For example, the ideology of Islamic finance claims that Islamic banking is superior to conventional finance with respect to efficiency (allocation), justice (distribution), and stability - provided that Islamic banking is based mainly on profit and loss sharing (in the financing business). This assumption is extremely unrealistic. Islamic banking is economically still deeply rooted in the mechanics of "fixed rates of return," which come close to interest under a different name. It took quite a while for chief executives and Muslim scholars to acknowledge this discrepancy between the ideology and the practice of Islamic banking. Although arguments can be found why in a transition period or in a mixed system Islamic banks cannot have recourse to the more distinctive (profit- and loss-sharing) instruments of Islamic finance, employees and managers of Islamic banks often had a hard time explaining to skeptical clients and outside observers what the substantial difference between their modes of finance and those of conventional banks is. The identification of staff with the larger (systemic) goals of Islamic finance became even more difficult when it was discovered that some Islamic financial institutions earned (or lost) much money in international commodity and currency transactions. The potential for disappointment and frustration could be reduced

- by more realistic and phased mission statements of the Islamic finance institutions, but also by sufficient realism in external academic and training courses.
- Accountability versus paternalism: In many enterprises, job satisfaction and motivation were boosted by giving more operational autonomy and responsibility to staff and lower-level managers. However, the literature on business cultures usually assumes a paternalistic management style in Arab and other Muslim countries. This is supplemented by the observation that professional careers often depend less on individual performance and more on memberships of networks (defined by family relations, geographic origin, and so on). A network factor also plays a role with respect to customer-related decisions: members of some networks may get a preferential treatment when it comes to the financing of projects. Paternalistic and network interventions are of particular relevance for those Islamic financing techniques which are based on risk and return sharing and require the assessment of business plans and project proposals. If a preferential treatment of some clients is the consequence of an intervention from higher management levels, then equal cases are not treated equally, and the accountability for decisions becomes blurred. Such practices impede effective teamwork, undermine the idea of participation, and obstruct performance-based human capital strategies. If there is indeed a general tendency toward paternalism and rent seeking in the business culture of Muslim countries, it is of great importance that Islamic financial institutions explicitly decide to break with this tradition and implement safeguarding organizational structures. Empirical studies on this topic are highly desirable but still lacking.
- Learning traditions and use of knowledge: Another element in
  Middle Eastern societies could pose a threat to a rapid human
  capital development in Islamic finance namely, the general
  learning and education culture. The second Arab Human Development Report, published by the United Nations Development
  Programme (UNDP) in 2003, deals with many shortcomings
  of education systems based on traditional authority (accepted
  without reflection), learning by heart, and uncritical reproduction. If this characterizes the learning habits of people, then an
  industry operating in a dynamic environment with innovative,
  knowledge-based products will run into trouble if its personnel

have such a mindset: the contribution of an institution's own personnel to the evaluation and improvement of products, procedures, and strategies is much more important for innovative Islamic finance institutions than for conventional banks. But an effective contribution of the institution's own employees requires the readiness of hierarchically lower staff members to articulate critique and the willingness of hierarchically superior managers not only to accept critique from below but even to attach a positive value to it. It seems that neither the learning culture nor the paternalistic management style encourages constructive critique. Thus, there is a risk that valuable potentials of the human capital of Islamic finance institutions will lie idle.

Some of the arguments indicating potential obstacles to the unfolding of the human resource potentials of Islamic banks are a bit "cloudy," but this does not mean that they are irrelevant. The softness of the arguments points to a huge backlog in empirical research at the firm level.

# 3. SUPPORT INFRASTRUCTURE FOR ISLAMIC FINANCIAL INSTITUTIONS

Many Islamic banks have the character of universal banks – that is, they have to provide services in a wide range of markets, from retail banking to investment banking. Given the scarcity of qualified personnel, it is a serious challenge to be competitive. The generation of information and the dissemination of market-related and company-specific knowledge among the staff members become crucial tasks. In recent years a number of institutions and companies emerged which provide specialized information and consultancy services, ranging from market data to legal advice and company ratings. This allows (especially smaller) Islamic banks to replace some in-house activities by the purchase of external services at lower cost or higher quality. The emergence of a support infrastructure improves the competitiveness of Islamic financial institutions against Islamic products and subsidiaries of conventional banks.

## 3.1. Knowledge Management in the Islamic Sector

Industry-wide institutions (for example, associations, federations) could help to solve some of the human capital problems of Islamic

finance companies that were indicated above. In addition, industry-wide institutions may play an active role with respect to the knowledge base and knowledge management of Islamic financial institutions – for example, by maintaining databases, disseminating best practice examples, formulating guidelines and minimum standards, negotiating with national and supranational regulators, lobbying for Islamic finance, or conducting market research. A high-quality support infrastructure can boost the effectiveness of the scarce and expensive human capital in individual firms of the Islamic financial services industry. The production of financial services is primarily based on financial resources and on knowledge – in particular, on the knowledge of how to mobilize and employ funds in a profitable and Shari'ah-compliant way, how to meet the demands of depositors and entrepreneurs, how to reconcile conflicting interests of clients, and how to adapt to legal and regulatory requirements.

For its continued existence and growth, the Islamic financial sector has to manage different types of knowledge:

- Individual knowledge is company- or business-related knowledge embedded in people who work for Islamic financial institutions. Relevant parts of individual knowledge are tacit and non-transferable; if an individual leaves the company, his or her tacit knowledge will be lost and the human capital of the company (not necessarily of the sector) will be reduced.
- Organizational knowledge originates from and relates to the operations of an individual Islamic financial services firm. It is a largely explicit and codified knowledge (for example, written down in procedural manuals, explicated in standard contracts, and so on), and it is transferable. This type of knowledge rests within the company and it can be transmitted to new personnel. The organizational knowledge includes the corporate culture or the business style of a company, which may not be written down (that is, it may not be fully explicit or codified) but which nevertheless can be transmitted to new members of the organization. The organizational knowledge manifests itself as an intangible asset that contributes to the market value of a firm.
- Sectoral knowledge is industry-specific knowledge shared by all Islamic financial service companies and related to all aspects which distinguish Islamic from conventional finance. Very

often, sectoral knowledge is gathered and disseminated by industry-specific associations with a broad membership or support base from Islamic financial institutions. The dissemination of sectoral knowledge may be directed toward internal and external addressees. Internal addressees are the members of the association who receive, for example, industry data for benchmarking purposes, best practice examples, recommendations for accounting procedures, general legal advice, or industry forecasts. External addressees receive, for example, basic facts and figures about the industry, information on job requirements and employment opportunities, or shared views and opinions on envisaged regulations. In the early years of Islamic finance (the late 1970s to the 1980s) the International Association of Islamic Banks played - to some degree - such a role, but with the growth and diversification of Islamic finance it has become de facto ineffective. Somewhat surprisingly, no successor has been established. In some countries (for example, Bahrain and Malaysia), central banks satisfy external information needs. Some internal services are provided by training institutions, as mentioned above, and by widely recognized expert bodies for legal and accounting issues such as the Islamic Figh Academy of the Organization of the Islamic Conference or the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) (see below).

A firm's position in intra-industry competition (that is, competition among Islamic financial institutions) depends mainly on the first two types of knowledge (individual and organizational). Human capital management is in large part about the generation, utilization, and retention of tacit individual knowledge. Organizational knowledge is a major topic of research work and consulting activities under the headlines of knowledge management and learning organizations. On the one hand, knowledge is a major input for the production of Islamic financial services. On the other hand, the generation and application of new knowledge in Islamic finance (for example, in the form of interest-free financial engineering or new laws and regulations) take place at a fast pace. Thus, Islamic financial institutions must pay attention to the knowledge dynamics in their markets and surroundings and to information and communication technologies.

## 3.2. External Expertise Supplementing Internal Competencies

For the growth of the whole Islamic finance industry, sectoral knowledge becomes crucial. The activities of financial services firms in the conventional sector are backed by a huge knowledge base. For example, a very large number of conventional banks and other financial institutions have been operating all over the world for decades (or even centuries); business practices are well documented, profit and loss accounts and balance sheets of many banks are published and subject to intense analysis and media coverage; depositors and lenders are well informed about the industry: finance and banking has grown into an advanced and diversified academic discipline: accounting, legal, and regulatory standards have evolved gradually; banks and other financial institutions as well as money and capital markets have overcome national or regional fragmentations and form a global finance network. Compared to this level of development, the Islamic financial services industry is still in its infancy. The number of actors as well as their sizes are relatively small; the range of products is still rather limited on the one hand but confusingly differentiated in details between banks on the other hand; comprehensive financial disclosure is more the exception than the rule; benchmarks are rare and media reports are more directed toward insiders than toward the general public: many, if not most, clients of Islamic banks have only a very limited knowledge about the specifics of Islamic finance; the academic community (inside and outside the Muslim world) is only gradually recognizing Islamic finance as a subject for serious study and research; accounting practices, legal requirements, and regulatory procedures still differ considerably between different countries; Islamic financial markets are geographically still fragmented and lack the depth and sophistication of conventional financial markets, and a global Islamic finance network is a desire but not vet the reality.

Specialized service providers could reduce the human resource requirements and enhance the performance of Islamic banks by providing specific services at lower costs than those resulting from in-house production in an individual bank. Specialized companies could, for example,

- reduce the cost of data and information collection and processing
- collect case studies and identify best (or worst) practice examples of techniques, operations, structures, and so on

- organize data and design methodologies for benchmarking and performance assessments
- provide expertise to Islamic banks for organizational, legal, and marketing issues,

Recourse to external service providers can enhance the efficiency of a bank's personnel in its daily operations. Gradually a support infrastructure comparable to that of the conventional finance sector is emerging. Examples of institutions and companies are as follows:

- Research relevant to the development of Islamic financial markets, the collection and dissemination of sector data and case studies, as well as training for practitioners is on the agenda of the Islamic Research and Training Institute of the Islamic Development Bank in Jeddah.
- Accounting, auditing, and governance issues are tackled by AAOIFI from the business perspective and by the IFSB from the regulators' perspective. Both AAOIFI and IFSB develop guidelines and standards for operational and structural issues. The adoption of these accounting, auditing, and governance standards reduces the need for the development of individual solutions that is, less manpower is needed in these fields. In addition, AAOIFI and IFSB standards should be included in academic programs and training courses of the specialized educational and training institutions for Islamic bank personnel mentioned above. This implies a further indirect reduction of human resource costs for Islamic banks.
- Each financial institution has to observe its specific market segments, but for benchmarking and planning purposes it also needs more general market data. Companies with a strong reputation for data collection and processing for conventional financial markets have entered the Islamic segment. Dow Jones & Companies and FTSE (a company owned by The Financial Times and the London Stock Exchange) publish Islamic market indexes. They reflect the performance of Shari'ah-compliant stocks traded globally or in specified regional markets. In addition, several investment consultants (mainly located in the U.K., often with branches or representative offices in the Middle East) offer investment advice and consultancy services to Islamic financial institutions.

- More complex financial deals require special legal expertise, especially if contracts shall be designed which are in conformity with Shari'ah law and the secular commercial law of one or more states. Specialized law firms (again mainly located in the U.K. and the U.S. with a presence in the Middle East) provide such services. Representatives of law firms and other consultants such as accounting firms are often listed as speakers at numerous Islamic finance seminars and conferences. Only the services of highly specialized consultants allow smaller Islamic banks to participate in or even to launch complex financial transactions. The frequency of such transactions is too low and the cost of highly specialized experts is too high. Similarly, the availability of external legal advice reduces costs for the design of more complex, innovative Islamic products.
- A recent addition to the support infrastructure of Islamic financial institutions is the Islamic Rating Agency, which has started to rate sukuk in order to give these Islamic products more credibility and thus improve the prospects for placements in conventional international financial markets.

Human resource problems of Islamic banks could be reduced by recourse to external service providers on a case-by-case basis. The support infrastructure of the Islamic sector has not yet reached the level of sophistication of the conventional finance sector, but the development has been accelerating since the late 1990s. A very remarkable evolution has started recently with respect to the verification of Shari'ah compliance of innovative Islamic products.

#### 4. SHARI'AH COMPLIANCE ISSUES

The top management of Islamic financial institutions has to identify the present and anticipate the future financial needs of entrepreneurial clients as well as of savers and institutional investors. This requires farsightedness with respect to the development of the Islamic and conventional financial markets and ideas about structural developments of the national and international economy as they determine the financial needs of the various economic actors (households, enterprises, governments, and so on). It is a major challenge for the leadership and top management of Islamic financial institutions to anticipate future needs and demands, to develop innovative products in due time, and to prepare the institution for the provision of new services. This is no

different from what is expected from chief executives of conventional banks. However, the top management of Islamic banks could be more restricted than that of conventional institutions. Besides general legal requirements and state regulations, managers of Islamic financial institutions are subject to an additional restriction – namely, the necessary Shari'ah compliance of all instruments and procedures.

The first Islamic banks set up Shari'ah boards and gave them the authority to decide on the permissibility of particular techniques, instruments, and products. In the early years, the Shari'ah boards rejected quite a number of proposals submitted by the management. Shari'ah boards screened all contracts used by the bank and monitored its activities. But over the last decade it seems that the basic attitude of Shari'ah boards has changed. Their verdicts have become far less restrictive and much more permissive. Thus the spectrum of Islamic techniques and products could widen considerably.

This is somewhat counteracted by governments of several Muslim countries who have declared AAOIFI standards binding for Islamic financial institutions. Some countries such as Sudan and Malaysia even went one step further and installed national bodies as the highest authorities for Shari'ah compliance assessments – the Sharia High Supervisory Board in the Bank of Sudan (established in 1993) and the National Syariah Advisory Council on Islamic Banking and Tahaful (established in 1997 by Bank Negara Malaysia). The discretionary power of individual Shari'ah boards of Islamic banks is seriously constrained where binding standards and supreme Shari'ah authorities exist. However, the advantage of such measures is that they enhance the consistency and credibility of Islamic finance in general, and Islamic financial institutions do not need to employ human resources for the production of this public good.

# 4.1. Changing Attitudes of Shari'ah Supervisors: From Restrictive to Permissive

AAOIFI has issued the Governance Standard No. 1 on the "Shari'ah Supervisory Board: Appointment, Composition and Report." According to this standard, every Islamic financial institution shall have a Shari'ah Supervisory Board (SSB) which is "an independent body of specialized jurists in figh al mua'malat (Islamic commercial jurisprudence) ... entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic Shari'ah Rules

and Principles." It shall "consist of at least three members" who are "appointed by the shareholders... upon the recommendation of the board of directors." The "management is responsible for ensuring that the financing institution conducts its business in accordance with Islamic Shari'ah Rules and Principles."

It should be noted that the AAOIFI Standard does not contain any information on the duration of an SSB membership and on the possibilities and procedures of dismissal and re-appointment. Despite the AAOIFI Standard, the specific rules and criteria for the selection and appointment of SSB members, as well as the quantitative and qualitative dimension of their financial and non-financial rewards, are not well documented in sources open to the general public. Following the guidelines of AAOIFI, the board of directors suggests the candidates for the SSB and determines their remuneration. Very often the management has a strong influence on decisions of the board of directors. Therefore, it is plausible to assume that top executives will have a strong influence on the composition of the SSB and on the financial and non-financial rewards for SSB members. Empirical research on the selection process of SSB members and their professional careers (before, during, and after the membership) is still lacking.

If the membership in an SSB promotes the achievement of individual goals of Shari'ah scholars, it is plausible to assume that SSB members are interested in re-appointment. This creates a de facto lack of independence from the board of directors who suggests candidates and determines the remuneration, and from the shareholders who appoint the SSB members. In addition, SSB members have to be aware that the interests of the management may be well represented in the board of directors. This all leads to the hypothesis that SSB members will not ignore the interests of the management when they apply their interpretation of Shari'ah principles to the activities, contracts, and transactions of their Islamic bank. This does not mean that they always find ways to accept whatever new financial product or transaction is submitted by the management. It must be a prime concern of the SSB that the Islamic character of the institution is recognized by the general public. But the SSB must also bear in mind the survival and commercial success of the institution.

Since the establishment of Islamic banks in the mid-1970s, it had become apparent that traditional contracts of the Islamic commercial law could not be applied directly to present-day transactions but had to be modified considerably (for example, mudarabah for ongoing concerns instead of terminated deals). In addition, some of the most highly esteemed contracts (mudarabah, musharakah) implied a possible adverse selection problem¹ and were neglected by Islamic bank managers, while new instruments had to be designed for new and more complex financing tasks unknown to the traditional Islamic law (for example, project or infrastructure financing, financing of working capital, consumer finance). Furthermore, instruments for efficient liquidity management and for the development of an interest-free capital and money market were urgently needed. Therefore, the managers of Islamic financial institutions came out with many new techniques and products whose Islamic qualities had to be assessed.

With the rapid growth of the Islamic financial sector, central banks and regulatory authorities paid more attention to this sector. They strongly supported the activities of organizations such as AAOIFI and IFSB in order to create a coherent legal and regulatory framework. This led to an increasing standardization of Islamic contracts and techniques. When standard techniques become part of everyday life, financial innovations become the major instrument for Islamic banks in their competition among each other and with Islamic products or subsidiaries of conventional banks. Standardization curtails the importance of the SSB for the "daily business" of an Islamic bank² but emphasizes the SSB's importance for financial innovations. Such innovations are designed and engineered by the management before they are submitted to the SSB for Shari ab sanctioning.

In a highly competitive environment, the perspectives of a bank will depend crucially on its innovative potentials. In order to keep a competitive edge and to protect against rapid imitation, neither the management nor the SSB of an innovative Islamic bank should have an interest in too much public disclosure of the commercial and Islamic qualities of financial innovations. Islamic banking is by its character more complicated (because it has to meet the requirements of the secular and the Islamic legal system) and in some ways less transparent than conventional banking. The need to keep "Islamic business secrets" makes it even more opaque than ribabased banking. Credibility for the Islamic qualities of the products and transactions is achieved not by disclosure but by the reputation and public recognition of the members of the SSB.

In contrast to the early years when Shari'ah opinions restricted the scope of instruments and products of Islamic banks, today's SSBs seem to be much more permissive. A legalistic view has become dominant which decomposes complex financial techniques, products, and contracts into a number of more basic components that resemble (or are identical with) legal figures of the traditional Islamic commercial law.<sup>3</sup> The Shari'ah quality of these components is then assessed for each component separately. If no objections are raised against any component, the total product gets sanctioned. This method seemingly supports financial engineering and product innovation in the Islamic segment of the financial market, but it has one very serious weakness: elements which are perfectly legitimate separately may interact in such a way that the result seemingly comes into conflict with fundamental principles of Islamic law. The dispute over the legitimacy of banking practices in Pakistan is a well-documented historical case, and questionable public debt issues in the form of sukuk are more recent examples.

It seems that a sufficiently large number of clients of Islamic banks and public opinion leaders do not require a very strict adherence to instruments and techniques of the traditional Islamic business law. They are satisfied with the observance of legal minimum requirements. The ideological impetus of the early years has become a minority position. External and internal factors can explain why SSBs have adopted a more permissive attitude toward financial innovations.

## 4.2. A New Role for Shari'ah Supervisory Boards?

If Shari'ah compliance criteria for techniques and products will be defined more precisely by authorities external to the individual Islamic bank, the individual SSBs will formally lose substantial competencies. However, this competence was eroded already de facto when SSBs adopted an increasingly permissive attitude toward financial innovations.

If Muslim states transfer the basic *Shari'ah* sanctioning from internal SSBs to external authorities (such as a National *Shari'ah* Board), the continuation of individual SSBs can be justified by two other major functions, the auditing and the marketing function:

The auditing function means that an SSB shall audit the procedures and products of its bank and issue (or refuse) a Shari'ah compliance certificate. However, the value of such a certificate can be disputed for various reasons. For example, the SSB audit is an internal audit whose quality crucially depends on the factual independence of the SSB members. Its value depends further on how detailed and thoroughly the SSB is able to examine

procedures and products.<sup>4</sup> Some questions may arise when the meetings of an SSB are not very frequent and short, and when its members have a considerable number of similar appointments with other institutions. For many stakeholders of an Islamic bank, not an internal, but a professional, external Shari'ah audit would ensure the Shari'ah compliance. Most probably, large and diversified international assurance and auditing firms with a long-established presence in the Muslim world (such as PricewaterhouseCoopers, Ernst & Young, or KPMG) could provide such services – either directly or through subsidiaries. These firms have gained a lot of insights and expertise in past years as conventional auditors of Islamic financial institutions and as providers of advisory services to conventional banks with Islamic products or subsidiaries.

The marketing function means that for many clients the Islamic credibility of products is not based on disclosure but on the reputation of SSB members. But this may change in the future for the attractive segment of high-net-worth individuals or institutional investors who are looking, for example, for more advanced investment options with more return, liquidity, and transparency. The challenge for SSBs can come from financial and law firms who have managed to bundle top-level financial engineering with first-class Shari'ah expertise and intimate knowledge of the relevant markets, backed by a financially powerful partner. The first of this new type of commercially minded think tanks for the Islamic finance sector is Dar Al Istirhmar, which was established in 2005 as a joint venture between Oxford Centre for Islamic Studies, Russell Wood Limited (a renowned investment advisor in the Middle East), and Deutsche Bank - the latter being the driving force behind the venture.

These trends, taken together, suggest that the importance of SSBs and individual Shari'ah scholars will decrease in the medium term while state-sanctioned or public authorities and specialized service providers may increasingly influence the development of the Islamic finance system. The Islamic and the conventional financial sectors will move closer to each other, and formerly clear demarcation lines may become further blurred in the not too distant future. This poses a formidable challenge to the top management of Islamic banks. To prepare for such a development (or to prevent it), future studies

and scenario exercises may be needed - techniques which are not yet on the agenda of training companies, course providers, and seminar organizers.

#### **ENDNOTES**

- Entrepreneurs who choose to have recourse to a profit-sharing mode of financing instead of a fixed-return based mode with a repayment obligation are more likely to be default-prone or to declare losses falsely when in fact a profit has been made.
- <sup>2</sup> Except for compliance monitoring the auditing function (see Sub-section 4.2 below).
- 3 See also Chapter 7 by DeLorenzo and McMillen in this volume.
- <sup>4</sup> In general, Shari'ah scholars have no competence in auditing. They can, however, act in liaison with internal auditors (as proposed in the AAOIFI Standard on Internal Shari'a Review) as well as with external auditors.

# CHAPTER 21

# Concluding Remarks

Simon Archer and Rifaat Ahmed Abdel Karim

#### 1. INTRODUCTION

The regulatory challenge as presented in this book concerns not just the industry regulators and supervisors and the international body they have set up, the IFSB, but the Islamic banks themselves and the governments and legislative authorities in the countries where they operate. The challenge to industry regulators and supervisors is no doubt the most obvious, in view of the characteristics of Islamic banks as both bankers and asset managers subject to a requirement for Shari'ah compliance that is fundamental to their relationship with the major part of their clientele - characteristics which mean that they cannot be supervised in the same way as conventional banks. For example, in countries that do not have an integrated financial supervisor they may require supervision by an investment industry or securities market supervisor, as well as by a banking supervisor. The fact that Islamic finance is in a rapidly evolving stage of development, in terms of its products and techniques, adds to this challenge. For the Islamic banks themselves (or, more generally, the Islamic financial services industry sector), the challenge is to be proactive in adopting operational policies and practices that meet international standards of risk management, transparency, and corporate governance, going beyond 'box-ticking' minimalist compliance, so as to facilitate the task of the industry supervisors. The challenge to national governments and legislative authorities is perhaps less widely recognised and is

twofold: to ensure that the industry regulators and supervisors have the necessary powers to perform their functions effectively; and to develop the national legal infrastructure so as to address the problem of legal uncertainty that was highlighted in Chapter 7. In addition, national authorities need to avoid the danger of legislative or regulatory over-reaction to certain types of risks or threats, as noted in Chapter 18.

# 2. THE CHALLENGE TO FINANCIAL SECTOR INDUSTRY REGULATORS AND SUPERVISORS

The authors of Basel II were well aware of the supervisory burden involved in the implementation of the framework and placed emphasis, in Pillars 2 and 3, on the supervisory evaluation of risk management and corporate governance, and the roles of transparency and market discipline, in facilitating the supervisory task. Chapters 8 and 12 demonstrate that issues of Shari'ah compliance do not present a significant problem for supervisors. Research shows, however, that in the majority of the countries where Islamic banks operate, their transparency leaves much to be desired, and so, in parallel, does the market discipline to which they might be exposed. Typically, these countries have a weak information environment characterized by a paucity of information intermediaries; such an environment neither encourages transparency nor fosters market discipline.

One problem is that of financial reporting standards. The International Financial Reporting Standards (IFRSs) of the IASB are deficient when applied to Islamic banks, because they do not adequately cater for the latter's Shari'ah-compliant financial instruments and operations. For this reason, the Accounting and Auditing Organization for Islamic Financial Institutions was created in 1991 and has issued 18 Financial Accounting Standards (FASTs). In spite of the high quality of these standards, however, they have been adopted in only a handful of countries. One reason for this is the belief that it is not possible for one set of financial statements to comply with both IFRSs and AAOIFI's FASTs, the priority being given to IFRSs. This belief, which seems to have been based on a misunderstanding,1 is starting to have some justification as the IASB revises its standards and issues new ones (such as IFRS 7). With regard to the disclosure aspect of financial reporting, the IFSB is moving to issue a standard on Transparency and Market Discipline which will be compatible with IAS 32 and IFRS 7. In Chapter 19, reference is made to the possibility of a "virtuous circle" whereby transparency and market discipline may be "bootstrapped" by the supervisor first requiring greater transparency ("sufficient information"), while market participants (with the help of information intermediaries such as credit rating agencies and financial analysts) need to have the ability to process the information correctly. "Bootstrapping" may be expected to occur because once sufficient information becomes available, information intermediaries will start to use it and the information environment will therefore strengthen, so that in response market discipline may be expected to develop, thus encouraging further transparency.

In some jurisdictions, financial sector industry supervisors may lack the powers to apply the "arm twisting" required in order to enforce compliance. Alternatively (or additionally) they may also lack the trained personnel needed for this. Such issues are matters for governments and legislative bodies, as discussed below.

# 3. THE CHALLENGE TO THE ISLAMIC FINANCIAL SERVICES INDUSTRY SECTOR

The modern Western banking and insurance industries started their development over 300 years ago, in the mid-17th century, when developments in mathematics and statistics provided powerful tools for financial mathematics and actuarial science which were paralleled by the emergence of a number of major banks and of the Lloyd's insurance market in England. These tools were further developed over the following centuries, also influencing the development of economics, especially in the late 19th and early 20th centuries, which saw the beginning of modern financial economics with work such as that of Jevons, Böhm-Bawerk, and Fisher. Such tools, however, were and are largely interest-based as well as having other characteristics that are not Shari'ah-compliant.

There was no parallel development of Shari'ah-compliant tools in the Muslim world, then dominated (and in the Middle East and North Africa, controlled) by the Ottoman Empire, which did not accord priority to institutional development. The Ottomans, in their complacent belief that the Muslim world maintained the intellectual and cultural superiority over Western Christendom that it had possessed in the centuries preceding the Renaissance in Western Europe, did not encourage their subjects to participate in the major developments taking place in the latter.<sup>2</sup> This complacency extended to

financial services; in the Ottoman Empire, commerce relied on forms of financing that did not involve banks as financial intermediaries, such as the use of the *mudarabah* contract.

Hence, the modern Islamic financial services industry finds itself having to devise, in the space of a few decades, Shari'ab-compliant alternatives to non-Shari'ab-compliant techniques that have evolved over more than three centuries. The challenge to the Islamic financial services industry is to achieve the rapid development of such alternatives while proactively meeting international standards of risk management and corporate governance.

A key role in these vital developments belongs to the experts in figh al mua'malat (Shari'ah commercial jurisprudence) on whose opinions the industry and its Muslim customers depend for assurance that the products and services offered are Shari'ah-compliant. Such experts are generally referred to as "Shari'ah scholars." In Chapter 7 of this volume, DeLorenzo and McMillen comment as follows: "Whatever questions, reservations, or doubts the critics of modern scholarship may have on this subject, the fact that Shari'ah boards [composed of Shari'ah scholars] have been able to achieve consensus on so many key issues suffices to establish the legitimacy of modern Islamic finance, and ... sets the stage for the establishment of industry standards which may, in turn, provide the impetus for real industry growth."

Yet, while the epithet "learned" is used to refer to lawver members in the U.K. parliament (as in the expression "the honorable and learned member"), a practicing lawyer is required to be more than a scholar, and the continuing use of the term "scholar" to designate Shari'ah jurists is indicative of a problem: namely, that they commonly lack the training and experience as commercial lawyers that is expected of experts in secular commercial law, as well as the educational facilities and professional organizations through which the latter achieve professional status and maturity. This hampers the ability of Shari'ah jurists to play the key role that is theirs in Islamic finance. As Nienhaus comments in Chapter 20 of this volume, the challenge to Shari'ah boards as presently constituted can come from financial and law firms who have managed to bundle top-level financial engineering with first-class Shari'ah expertise and intimate knowledge of the relevant markets, backed by a financially powerful partner. By implication, this comment is also applicable to the concept of the Shari'ah "scholar" which still remains prevalent.

# 4. THE CHALLENGE TO GOVERNMENTS AND LEGISLATIVE AUTHORITIES

DeLorenzo and McMillen comment in Chapter 7 of this volume that achievement of the benefits, both macroeconomic and microeconomic, of securitization in the field of Islamic finance will depend on, among other things, sukuk issues being able to obtain credit ratings from major international rating agencies, which depends, in turn, upon obtaining acceptable legal opinions on a range of true sale, collateral security, bankruptcy, and other legal issues. But they note that it is clear that such opinions are unobtainable in current circumstances, given the state of development of these legal areas in many jurisdictions within the Islamic economic sphere, and they call for action and legal reform – in particular, the reform of secular law in jurisdictions within the Islamic economic sphere.

These tasks represent a major challenge to the governments and legislative bodies in these countries, all the more in that most of them have code-based rather than common law-based legal systems. Islamic finance is essentially built on a set of (nominate) contracts, and common law jurisdictions with their law of contract seem to be more ready than code-based jurisdictions to adapt to the need to handle the legal issues raised by Islamic finance which involve the interpretation and enforcement of Shari'ah contracts.

One attribute that a legal infrastructure for financial transactions must possess is a reasonable degree of legal certainty. It is, above all, the lack of this attribute which leads to the problem noted above - namely, that of obtaining acceptable legal opinions on a range of issues such as true sale, collateral security, bankruptcy, and other legal issues, which is a requirement if Islamic finance is to develop as a fully-fledged alternative to conventional finance. From this perspective, the tradition of figh al mua'malat, with the importance given to the personal opinions of individual Shari'ah scholars, even if consensus between them is also accorded great importance, stands in stark contrast to the concept of "positive law" as an objective social fact that is prevalent in Western jurisprudence.3 In common law-based systems, a key source of legal certainty is the principle of stare decisis, or judicial precedent, whereas in code law-based systems, legal certainty requires legislation - that is, the promulgation of an applicable law or legal code.

One major challenge to governments and legislative authorities is thus to find a means whereby an applicable body of "positive law" may be developed in order to provide an effective legal infrastructure for Islamic finance. Another major challenge to such authorities, as noted above, is to equip the supervisory and regulatory bodies concerned with Islamic finance with the authority and the means to perform their functions effectively.

#### 5. CONCLUSIONS

We have summarised in this chapter what we see as the dimensions of the regulatory challenge arising out of the development of Islamic finance and the social and economic need for it to develop further. This need has a certain degree of urgency insofar as it is both unacceptable and potentially dangerous for a large section of humanity to be deprived of fully competitive financial services because of the lack of Shari'ah-compliant alternatives to conventional financial products and structures.

While the industry regulators and supervisors are in the front line facing this challenge, in fact the challenge is much wider, and confronts the firms competing in the industry at the micro level and the governmental and legislative authorities in the host countries at the macro level. It also confronts the profession of experts in Shari'ah commercial jurisprudence, and those educational institutions in which they study, with the need for a greater awareness of the characteristics required by an effective legal infrastructure for Islamic finance. This would apply in jurisdictions where the applicable law is the Shari'ah, as well as those mixed jurisdictions where it is partly Shari'ah-based and those where Shari'ah is not part of the legal system but where financial arrangements based on Shari'ah contracts need the requisite legal support.

The countries that act as hosts to Islamic financial institutions comprise a number of predominantly Islamic states with emerging markets, as well as other states with highly developed markets such as the U.K. The challenge facing the former countries is to provide an appropriate regulatory environment and legal infrastructure, given the other pressing demands made on limited human resources. The challenge facing the latter countries is to accommodate Islamic finance within a legal and regulatory infrastructure designed for conventional finance.

A typical problem in countries with highly developed markets is the legal definition of a "bank" as a "deposit-taking institution," deposits having the legal status of debt contracts and being "capital certain," whereas Islamic banks accept "deposits" as profit-sharing investment accounts which cannot be "capital certain" as the Shari'ah does not permit this; in other words, if the profit-sharing pool in which their funds are invested incurs a loss, the investment account holders must accept their share of the loss. From the narrow perspective of banking law, Islamic banks may better be termed finance bouses rather than banks stricto sensu, but they perform the economic function of banks to the Islamic community and may therefore quite reasonably wish to call themselves banks for marketing reasons.

Another potential problem arises from the fact that the "deposits" accepted by Islamic banks, insofar as they are a form of investment product (that is, a type of collective investment scheme – CIS), may fall to be regulated not by the banking industry supervisor but by the authority responsible for regulating CIS.<sup>5</sup>

One of the most egregious errors that has been committed by certain ideologists of "free markets" is the failure to acknowledge that markets (including, and indeed especially, financial markets) do not exist in a pure economic space, but are part of a societal structure of which the law and the administration of justice are key components, along with education and business ethics.<sup>6</sup> A major advantage of the Shari'ah in this respect is its insistence on the ethical dimension of business. We hope that the coming decade will see important advances in the adaptation of legal systems, in education and training, in regulation and supervision, and in other relevant aspects of institutional development, so that Islamic finance may fulfill its true potential.<sup>7</sup>

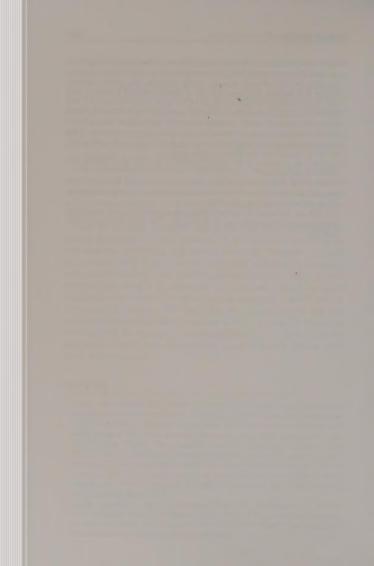
#### **ENDNOTES**

It appears not to have been generally understood that the rules for presentation and disclosure in FASTs are compatible with those in IFRSs, in that they complement rather than conflict with those in the latter, while the rules for recognition and measurement in FASTs are, or could be applied in a way that is, compatible with those in IFRSs, However, this compatibility may be jeopardized if IFRSs are revised or new IFRSs are issued and no corresponding changes are made to the set of FASTs.

<sup>&</sup>lt;sup>2</sup> As noted by DeLorenzo and McMillen in Chapter 7 of this volume, the Majalat al-Ahkam al-Adaliyah, which was in use throughout the courts of the Ottoman Empire, was originally prepared by Ottoman scholars of the Hanafi school of jurisprudence circa AD 1285.

<sup>&</sup>lt;sup>a</sup> See, for example, J. Raz, The Authority of the Law, Clarendon Press, Oxford, 1979. Whatever might be thought about the merits of legal positivism in general, the lack of "positive law" in commercial and financial matters is undoubtedly an obstacle to the development of financial markets.

- In the case of the Islamic Bank of Britain (IBB), established in 2004, an accommodation was reached with the industry supervisor (the Financial Services Authority FSA) and IBB's Shari'ah advisors whereby a Muslim who opened a deposit account with the bank could waive his right to "capital certainty" following a loss. (See, for example, condition 6.3(d) in the IBB's Young Person's Savings Account Special Conditions.) In such a case, while it is clear that the Muslim depositor who waived his right to be repaid his capital following a loss would be in compliance with the Shari'ah, it is rather less clear that one could say the same in general of the types of deposit account offered by the bank. It remains to be seen to what extent this British example will be followed in other countries.
- 5 This was not a problem in the case of the IBB in the U.K., since the FSA is a cross-sectoral regulator.
- While the links between the development of markets and that of democratic institutions in general remain to be demonstrated, those between markets and the rule of law are being increasingly recognized.
- <sup>7</sup> The IFSB and the Islamic Development Bank (one of its member institutions) have drawn up a draft Ten-year Plan for the development of the Islamic financial services industry.



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